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EMPLOYER RETIREMENT PROGRAMS AND SOCIAL SECURITY

STATEMENT OF J. JACKSON WALTER, MODERATOR, PRESIDENT, NATIONAL ACADEMY OF PUBLIC ADMINISTRATION

(The Forum met at 1 p.m., Tuesday, April 17, 1984, in room SD-106, Dirksen Senate Office Building.)

Mr. **Walter**. I am Jack Walter and I will be the moderator. I am the President of the National Academy of Public Administration.

For those of you who want some coffee, it is in the back.

On my left there are copies of the papers over next to the door that you came in. Today's papers are there as well as the printing of the first forum. We apologize that papers were not available prior to the forum.

I continue to urge you to move forward, we are going to have plenty of room. I will probably do it before the first person speaks.

I think most of you have been here at previous sessions and know generally what the format will be. We will run from now until we are finished or until about 5 o'clock. We have five speakers, each of whom will speak for about 15 minutes. We will have plenty of time for questions but roughly about the same amount of time for questions as we have for the presentation.

I simply repeat the instruction from the previous moderators which is when you have a question, please introduce yourself and the organization that you are representing.

I remind everybody what we have been reminded of previously which is that this is an informational forum, a learning process, and not a political debating society. Accordingly, I think we can leave our political points at the door and bring our curiosity about the pension program into the room and to the attention of the speakers.

This is the third in a series of what will be five forums. I think by all counts the first two have been very successful. I will remind you now of the subject matter—well, I will remind you momentarily. Senator Mathias is in the room and I will ask him to come forward.

I think we all know Senator Charles Mathias, Chairman of the Maryland Congressional Delegation, a Member of the U.S. Congress since 1960 who has served in the Senate since 1968. Senator Mathias is currently Chairman of the Committee on Rules and Administration and a member of three other committees: the Committee on Foreign Relations where he is the Chairman of its Subcommittee on International Economic Policy; a member of the Committee on the Judiciary where he is the Chairman of its Subcommittee on Patents, Trademarks and Copyrights; and a member of the Committee on Governmental Affairs where he is Chairman of its Subcommittee on Governmental Efficiency and the District of Columbia. He has had extensive service in Maryland government and in local government in the State of Maryland.

Senator, we are pleased to have you with us to open this, the third forum.

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. Thank you very much.

I am delighted to be here. In fact, you don't know how glad; I have just been sitting in a long line of traffic with a left lane closed for repairs and everybody jockeying to get in the right lane. Under those circumstances it makes it very problematical when and how you are going to get anywhere. So I am happy to be here not only to see you, but just to be here.

I am glad to have a chance to participate in this third Forum on Federal Pensions and to take the opportunity to thank each one of you for having participated and for offering ideas and suggestions because the Congress has a monumental task ahead.

When we voted to include new Federal employees in the Social Security system beginning on January 1 of this year, it really became incumbent upon us to redesign the current Civil Service Retirement System for those employees. I would emphasize "for those employees."

The size of the task and the kind of widespread effects that these decisions will have on pension policy throughout the United States demands that the Congress act with the fullest possible knowledge of all the options and of all of the consequences that can occur as a result of the changes. Those are sometimes more difficult to perceive than at first blush. That is what these five pension forums sponsored by the Senate Subcommittee on Civil Service, Post Office, and General Services are intended to accomplish.

You have an advantage on me because you have participated in the previous forums. The first session, last December, provided an overview of economic security programs and provided the essential groundwork of basic knowledge and terms. The second forum, held in February, focused on design issues and how individual components of a system can work together to maximize the stated policy. Today, the focus is a little narrower, a little more directed, because the third forum tackles the very complex issue of how Social Security can and ought to be integrated into an employee retirement program—how that could be feasible.

As is usually the case at major meetings of experts like this one, we are always pushed for time; therefore, I won't dwell on the importance of the job today or our great appreciation for the attendance and participation of each and every one of you. But before I turn things over to those who have been asked to prepare the papers for today's discussion, I do want you to know how pleased the subcommittee is with this process and with its product to date. We have managed to bring together leaders in the field of pension policy from business, from labor, from insurance, from the public sector and from private industry. This is enormously important because everywhere I go around the country I hear people raise the question of Federal pensions. They continually say, "why don't you do it as we do it in our business" or "why don't you do it as we do it in our company." What they really mean is "why don't you make it as tough as we have it." And so, this participation from all the different sectors of the American economy is an enormously important factor.

As we go along I think it becomes clear just how complex the pension policy is, how much there is to learn. In the end, I hope that we will be able to create a blueprint for employee retirement programs across the country—a sort of "state of the art" of pensions. With the fate of millions of civil servants—and more than that, the fate, in fact, of the entire Civil Service—in our hands, I think we simply have to succeed.

These forums have been exceptional due to the high level of participation and cooperation and discussion. On behalf of our Chairman, Senator Stevens, and on behalf of all the members of the subcommittee, I want to thank you for that and for continuing to give us the benefit of your expertise and knowledge. I don't have to tell you that a great deal is riding on your work.

Thank you very much.

Mr. **Walter**. Senator, thank you very much.

If I may get back to where I paused briefly—which was to point out when the fourth and the fifth of these forums will be—the fourth one will be on Pension Funding, Investment and Administrative Issues, an all day meeting beginning at 9:30 on May 30 and the fifth and final program on Program Options will be on July 10.

I think, Jamie, that you have done a swell job in putting this program together. In thinking briefly about the past two programs which I did attend, I realized to my pleasure the one thing that they had in common: the three Senators who were introduced at the first three forums—Senators Thurmond and Eagleton and now Senator Mathias—all were cosponsors of legislation that recently was signed by the President creating the National Academy of Public Administration, something that we are pleased happened this last Tuesday, a week ago today. So, Senator, we thank you for your cosponsoring that bill. It is not part of this program but it is just fine.

Our first speaker today is Larry Thompson who is the Chief Economist at the General Accounting Office, a position that he assumed last fall. Prior to coming to the GAO in September or October of 1983, he had worked for 9 years on income security issues in the Department of Health and Human Resources and this included service as Director of Social Security Planning in the Office of the Secretary, Executive Director of the 1979 Advisory Council on Social Security, Director of Research and Statistics of the Social Security Administration and Associate Social Security Commissioner for Policy.

With a Bachelor of Science degree from Iowa State and an M.B.A. from the Wharton School and a Ph.D. in Economics from the University of Michigan, Mr. Thompson is a career civil servant and clearly qualified and ready to open this, the third forum in a series.

We are pleased to have you here, Mr. Thompson.

I. SOCIAL SECURITY: HISTORICAL DEVELOPMENT AND CURRENT STRUCTURE, BENEFITS, AND CONTRIBUTIONS

(Presented by Lawrence H. Thompson, Chief Economist, U.S. General Accounting Office)

Mr. THOMPSON. Thank you.

My task is to describe the current Social Security system. As I do so, I have the feeling I am carrying coals to Newcastle, at least for many of you. Therefore, I will try to run through my presentation as quickly as I can, hitting essential elements and skidding over some of the details. There will be time for questions at the conclusion of my presentation, and you can get into the details then if you like.

I do have a paper which gets into more detail and a revised version of it is available here. One thing about Social Security is the cost estimates are updated frequently; the revised version incorporates the most recent cost estimates.

May I say also that I will feel free to give you my views as an observer of Social Security these many years if you will allow them to be my views and not necessarily those of the General Accounting Office.

Let me start off by saying that I see there being five essential elements to the Social Security program, some of which are similar to Civil Service retirement and some of which are different.

First, like Civil Service, Social Security is contributory, although in Social Security the employee's contribution provides pretty much half of the financing.

Second, Social Security benefits are earnings related. That attribute is also similar to Civil Service, but we shall see that the similarity can't be pushed too far. Social Security benefits represent a compromise between a desire to emphasize social adequacy and a desire to emphasize individual equity and, therefore, are structured quite different from benefits in most pension plans or in the Civil Service Retirement System.

Third, Social Security intends to only partially replace lost earnings, especially for higher income workers. The assumption is that higher income workers will supplement their Social Security benefits with some other form of retirement income, be it a private pension or be it private savings. This means, for example, Social Security benefits are paid without a means test. If you placed a means test on Social Security, you would in effect have a tax on private savings. The presumption was that people would save to supplement their Social Security; but only those who did save would lose benefits as a result of a means test.

Fourth, Social Security is current cost financed. That is dissimilar from the ERISA standard for the private sector and from the current practice for the Civil Service system. In Social Security it is more or less a matter of conscious policy that today's income is essentially the money used to pay today's benefits.

Finally, Social Security is the most portable pension in the United States. All employers who are covered participate in the same program so that all earnings credits earned by working for a covered employer are completely portable.

I will begin by describing the benefit structure. To be eligible for retirement benefits, you have to work a certain amount of time in employment covered by the program. For the purposes of this discussion, we can assume the requirement is 10 years, which is the rule that will be in effect for people turning 62 in the 1990's and thereafter. There are separate eligibility tests for disability benefits and for benefits to survivors of workers who die before reaching retirement age. For retirement benefits, the 10-year minimum translates into 40 quarters of employment under the program, but it can be employment with any covered employer; it could be one quarter of employment with each of 40 different employers.

The benefit calculation involves two basic steps. First is the calculation of the worker's average earnings under the Social Security program. This figure is called Average Indexed Monthly Earnings or AIME. In principle this is a calculation of the worker's career average earnings. The use of career averaging differentiates Social Security from most private pensions and from the Civil Service Retirement System. To avoid the problems that are presented by career averaging in an environment where wage and price levels have changed, the computation uses wage indexing of the past earnings values. Let me explain the mechanics.

Basically, you sum up all earnings in any given year from all employers and you multiply the total of the earnings actually credited that year by the amount that average wage levels in the economy have increased since the year the earnings were credited. Thus if you earned $3,600 in 1951, which was the maximum amount taxable that year, and you are retiring this year at age 62, that $3,600 will be multiplied by roughly 5.2 and will enter into the calculation as if it were $18,700. The logic is that $18,700 represents what 1951 earnings of $3,600 would be at today's wage levels.

Having wage indexed all of the earnings, you then pick the high 35 and average them. Actually today's retirees don't use quite as many years, but beginning in the 1990's all retirees will use the high 35. The calculation actually works on annual earnings figures, so the last step is to divide by 12 to get a monthly amount which is the Average Indexed Monthly Earnings for the individual.

Calculating average earnings in this way has several impacts. First, portability is maximized. All earnings credits from all employers are combined into one earnings record. Second, the procedure updates earnings from prior employers. Consider what a pension is worth today if it were based on the high 3, but it is from an employer that you left in 1951 and your high 3 was $3,600. That is not a very hefty benefit when it comes time to retire in 1984. Under Social Security, if you left the employer in 1951, your pension is not based on $3,600, it's based on the $18,700 produced by updating the earnings to the time of retirement. Finally, the process introduces, if crudely, a length of service adjustment, because if you don't have 35 years of positive earnings, zeros are entered.

The second step in the benefit calculation is computing the Primary Insurance Amount, which is the figure upon which all the monthly benefits are based. The PIA is computed through a three-step formula that is progressive and cohort specific. The formula for a worker who turns 62 in 1984 is 90 percent of the first $267 of AIME, plus 32 percent of the next $1,345, plus 15 percent of the remainder. Such a worker will have that formula used to compute his benefit no matter when he actually retires. The worker who turned 62 in 1983 has his benefits computed with a different formula. The difference is that the bracket boundaries—$267 and $1,345—are adjusted each year to reflect changes in average wage levels. In effect, the Social Security benefit formula is indexed to the average wage in much the same way the law provides that the income tax will be indexed in the future to the Consumer Price Index. The indexing of the benefit formula is to keep the structure of benefits up to date with average wage levels so that each cohort of retirees gets on average a benefit that is roughly the same fraction of preretirement earnings as was received by the previous cohort.

At the end of the calculation, you add all the general benefit increases that have occurred since the time the individual first became eligible for benefits. The result is the individual's PIA.

As I said earlier, the formula is structured to balance a concern for social adequacy with a concern for individual equity. The higher your earnings, the higher your benefit; but the higher your earnings, the lower the benefit is as a fraction of preretirement earnings. The idea is that the people who have the lowest earnings have had the least opportunity to save, are least likely to have private pensions and, therefore, are most in need of a replacement rate which approaches full replacement of previous earnings.

The effect of the progressive benefit formula is illustrated by benefit calculations for three illustrative age 65 retirees: one who always earned the minimum wage, one who always earned the average wage, and one who earned the maximum taxable all his career. Under current law the ultimate replacement rate will level off at roughly 40 percent for the average worker, it will be 55 percent for the minimum wage earner, and 28 percent for the person who always earned the maximum.

I said earlier that part of the reason for the progressive benefit formula was the assumption that higher earners would have private sources of retirement income to supplement their Social Security. The most common private source is a private pension. Table 4 in my paper illustrates how accurate the assumption is. That table shows the combined benefits of actual married couples who began retiring in the late 1960's and early 1970's. They are divided into earnings quintiles. In the middle column you see that the Social Security replacement rate declines as you go up the earnings distribution. Then you see in the last column how the total of Social Security plus private pension benefits also declines, but far less dramatically. The reason the pattern in the last column differs from the pattern in the middle column is explained in the first column. That column shows the fraction of couples in each quintile who are eligible for a second pension. It turns out that as you go from low earnings levels to high earnings levels, the replacement rate from private pensions does not vary nearly as much as does the fraction of couples who receive a private pension.

Now let me return to the Social Security benefit calculation. Once you have computed the primary insurance amount, you have to make adjustments for age of retirement and relationship to the worker in order to obtain the actual monthly benefit. For example, benefits are permanently reduced if drawn at age 62, but are permanently increased if first drawn at age 70. Also, various specified dependents of retired and disabled workers and various categories of survivors receive benefits defined as a particular fraction of the primary insurance amount. However, there is a maximum amount that can be paid on any one wage earner's record. Although it varies with the level of the PIA, essentially it limits total benefits to between 150 and 188 percent of the primary insurance amount. In effect, then, once you have a worker and two dependents drawing on one account, the family will simply receive the maximum benefit payable. It is also common to find that a worker is entitled to more than one kind of benefit, as, say, a worker and as the the spouse of a worker. These people are said to be dually entitled, and, in effect, they get the higher of two benefits to which they are entitled.

I said earlier that benefits were not subject to a means test but are subject to an earnings test. Under that test, pension and other nonlabor income of any amount is allowed; however, if earnings exceed certain amounts, Social Security benefits may be reduced. I think I can say without fear of contradiction, the earnings test is the single most unpopular provision of the program.

The reason to have an earnings test is the feeling that you need a test of retirement. No private pension, even the Civil Service pension, allows you to draw both a full benefit and a full salary if you are working in employment and covered by the pension system. Usually, you have to leave the firm or industry to get a full pension. The problem with Social Security is you can't very easily leave Social Security covered employment and still have a job. There is a recognition that many low wage people didn't have private pensions to supplement their Social Security check; there is a concern that we not discourage work among retirees needlessly; and there is a recognition that some people under Social Security never really retire, such as farmers. Thus, the Congress decided to allow full benefits even if the retiree has some work, but not to necessarily allow full benefits regardless of the amount the retiree works.

I am not going to defend any piece of the earnings test as being the most logical way of handling any one particular situation, because it is not. It should be viewed as a compromise that tries to handle conflicting objectives in a tolerable fashion. Under the earnings test you can have earnings of up to a little over $5,000 a year if you are under 65 and almost $7,000 if you are over 65, with no effect on your benefits. If annual earnings are higher than that, benefits are reduced by 50 cents for each dollar of earnings over the exempt amount. At age 70, the earnings test drops out, and benefits are paid regardless of the earnings level.

In 1983 legislation scheduled several future changes in the benefit calculation. One is in the delayed retirement credit, which is the amount by which your benefits are permanently increased if you delay retirement until after age 65. The credit is now 3 percent per year. However, if you were born after 1943, instead of increasing by 3 percent per year, benefits will rise by 8 percent per year for each year retirement is delayed. The 8 percent credit is close to being actuarially fair in the sense that at the average life expectancy you could expect the same present value of benefits whether you worked to age 67 or stopped at age 65. Another change modifies the retirement test effective in 1990. After 1990, people over age 65 with earnings in excess of the exempt amount will lose only 33⅓ cents in benefits for each dollar in excess earnings. Finally, the normal retirement age will be increased in two steps, first to age 66 and then to age 67.

Under the current schedule, when the normal retirement age increases, the age at which you are first eligible for benefits will remain 62. However, benefits taken at age 62 will be reduced by more than is the current practice. In fact, one can say that raising the retirement age is nothing more than another way of reducing benefits. Workers will still be able to get benefits at any time after age 62, but the benefits will be a smaller fraction of the PIA. At age 65 benefits will become early retirement benefits reduced by 13 percent rather than full retirement benefits, and at age 67 benefits will be just equal to the primary insurance amount rather than being increased by 16 percent because of 2 years of delayed retirement. So you can call this change either an increase in the retirement age or reduction in benefits; it all depends on which characterization you think most effectively makes the case that you want to make.

As you know, Social Security benefits are indexed automatically to the Consumer Price Index. You may not know that if the Consumer Price Index didn't rise by 3 percent in a given year, there is no cost-of-living adjustment. A special provision introduced by the 1983 legislation constrains the size of the cost-of-living adjustment under certain circumstances. This occurs when wages have been rising more slowly than prices and the trust fund balance is quite low.

And as you also undoubtedly know, beginning in 1983 benefits paid certain high income individuals are subject to the income tax. Up to one-half the benefit is taxable if income from other sources plus one-half of Social Security exceeds certain limits specified in the law. Two interesting features of this provision are: (1) that the additional income tax proceeds are deposited in the trust funds and become additional revenue to Social Security and (2) that the income limits are not indexed. Unless Congress changes the income limits, over time a greater and greater fraction of the American population will find that one-half of its Social Security benefits are subject to tax.

Social Security is financed virtually entirely from payroll taxes. In 1984 payroll taxes are projected to supply $180 billion of the projected total of $184 billion in revenue for the cash benefit program. The taxes are divided equally between employer and employee. There is a limit, a taxable maximum, of $37,800. The tax is levied on the first $37,800 of earnings each year, and is not levied on earnings above the limit. The exclusion of earnings above the limit is symmetrical; $37,800 is also the maximum amount of earnings that can be entered into the benefit calculation for 1984. The tax is collected from every employer you have, but the total amount of earnings taxed cannot exceed $37,800. If you have had more than one employer and aggregate taxed earnings exceed the limit, you can get a credit on your income tax the next year.

Over the years, the Social Security tax rates have gone up. The tax started off in 1937 at 1 percent on both employers and employees, levied on the first $3,000 of earnings. By 1983 the total tax rate had risen to 6.70 percent on the first $35,700. One interesting historical observation, however, is that $35,700 in 1983 earnings is actually fairly comparable to $3,000 in 1940 earnings. In both 1940 and 1983 about 90 percent of all earnings in employment covered by the program were taxable under the taxable maximum then in effect. Another interesting historical footnote is that a good part of the tax rate increase that has occurred was projected at the time the program started. Back in 1939 it was estimated by Robert Myers that in 1980 the cost of Old Age and Survivors Insurance would be something in the neighborhood of 10 percent of payroll; the actual OASI tax rate in 1980 turned out to be 4.5 each, or 9.0 percent of payroll. Thus, tax rate increases after 1940 either were foreseen at the time or the result of adding the disability insurance and hospital insurance programs to the Social Security package. However, the 4.5 percent tax rate in 1980 did not turn out to be quite enough to finance the program in the early 1980's, and as a result, further increases in the payroll tax were scheduled in 1983. Finally, I should note that the earnings base rises automatically at the rate that average earnings levels in the economy are rising, so what it will be in any future year depends upon future rates of wage growth.

The Social Security Administration prepares annual projections of future income and outgo for 75 years into the future. In these projections, income and outgo under current law are calculated using certain—it is hoped—plausible assumptions about the future economic and demographic developments. The projections are quite sensitive to the underlying economic assumptions and I want you to be forewarned that the projections are no better than the assumptions upon which they are based. Indeed, much of the problem in the 1970's and 1980's with Social Security finance can be traced to the fact that the assumptions used by the Social Security actuaries turned out to be too optimistic.

The most recent projections were released the week before last. Since at least 1975, there has been an almost continual decline in the ratio of reserves in the trust fund to expenditures from that fund, to the point that had I been here 2 years ago, the projections I would have been discussing would have shown exhaustion of the reserves in the near future. The 1983 legislation altered the picture by boosting reserves a little bit immediately and increasing projected revenues for the rest of the decade.

Under the "Intermediate B" assumption set, current projections now show that income exceeds outgo in each year, but, frankly, the balance is pretty thin between now and about 1987. There is a big tax increase now scheduled for 1988, so that after 1988, the projections show that things become a lot more flush. Even the latest

Trustees' Report warns, however, that it is not impossible to contemplate an economic situation in which the currently scheduled tax rates will be insufficient to fully fund on a timely basis the currently scheduled benefit payments. So the best guess right now is that the revenue-expenditure balance will be thin between now and 1988 but revenues will be sufficient. There are no money-back guarantees, however, that something won't go wrong and that the Congress won't be asked to make some more tax or benefit changes.

The 75-year projection shows program costs falling well below scheduled income for the next 30 years. Indeed, the demographics for the Social Security retirement program are favorable for the next 15 to 20 years because in these years the retirees are from the depression cohort and the baby boom cohort is in the work force. The demographics are not quite so favorable beginning about 2020 when the baby boom cohort reaches retirement age and they are followed by the baby bust cohort manning the work force. At that point, the cost of Social Security rises sharply.

The tax rate increase that is scheduled to go into effect in 1990 produces a very sizable surplus of revenues over expenditures. If you believe the assumptions and if you believe that the Congress will make no changes in the Social Security program over the next 30 years, the projections suggest the accumulation of huge Social Security reserves unprecedented in this Nation's history. I compute balances reaching 25 percent of the Gross National Product held in the Social Security trust funds. Those reserves are then drawn down after 2020 when annual income is projected to be below annual cost. As it turns out, the tax rates are set in such a way that under current projections, roughly speaking, the last dollar in reserves is used up right at the end of the 75-year projection period. So one can say that projected cost and projected income are balanced over the next 75 years, but there is actually a big surplus in the early years and a big deficit in the later years.

The results discussed so far are under the Intermediate B assumption set. There are actually four different assumption sets used in projecting Social Security. These different assumption sets contain different combinations of demographic and economic assumptions. Presumably the assumption sets bracket actual experience, but again there is no guarantee of this since making projections is an art and not a science. Under plausible, pessimistic assumptions in which people live a long time and the economy does not perform very well for a long period of time, the trust funds begin to run deficits in the early 21st century. The deficit becomes quite substantial in the last 25 years of the projection period and the system is in substantial deficit after about 2010 or 2015.

Under the optimistic assumptions, in which the birth rate picks up, people don't live quite so long, and the economy does fine, there is a substantial surplus over the whole 75-year period. The surplus averages 2.5 percent of taxable payroll.

That was Social Security as it exists today, once over lightly.

Mr. WALTER. Questions. I remind you when you have a question to identify yourself and the organization you are appearing for.

It is a consensus view is the only thing I can say.

Mr. FACCIANI. I am Jerry Facciani from Cleveland, Ohio.

Isn't it true, Mr. Thompson, that in a few years during the 1970's and 1980's that the Social Security projections on a worst case basis actually were not realized for purposes of financing benefits, and what would your 20 percent plus pessimistic assumptions be if you were actually plotting on a worst case basis?

Mr. THOMPSON. It is true that in the 1970's the pessimistic scenario was the better guess. I don't know whether actual experience was worse than the pessimistic assumptions, but it could have been worse; if actual experience was better, it was not much better.

Who knows what the economy is going to do? I will say this: The intermediate assumptions now are a good deal more pessimistic than the intermediate assumptions were in the 1970's. The misguessing of the economy was not something only Social Security did. If you look at old DRI forecasts, you'll find they were as wrong as the Social Security Administration's forecasts were. It just goes to show that nobody really knows what will happen to the economy in the future.

It is possible to come up with an economic scenario that will bankrupt the fund in 3 years. This would occur if economic developments in the next 2 years are as bad as what happened in 1980, 1981 or even 1975. I mean as bad in the sense of the sharp decline in employment and the sharp increase in inflation rates.

The current pessimistic assumptions contemplate a recession with the unemployment rate rising to 9 percent next year and drifting down slowly thereafter. They are pretty pessimistic. They are not the worst you can come up with, but they are pretty pessimistic. The system skates by just barely under those assumptions. By 1990 the economic environment doesn't make much difference, because the tax rate now scheduled is so high that it is almost implausible to think of an economic environment in which it would not be high enough. But the financial situation is still a little iffy between now and 1988 or 1989.

Does that answer your question?

Mr. FACCIANI. Yes, it does. I guess my only point is that I live in Cleveland so the pessimistic assumptions are probably pretty realistic. Maybe that is where I am coming from.

Second, I just want to point out that Social Security is such an important component in the whole retirement income delivery system that you have to be aware that it really hinges on some pretty exotic assumptions for future performance.

Mr. THOMPSON. Well, we always used to say that you have to be careful with these projections; that the financial future of Social Security—if you will, the security of Social Security—rested not on the projections of whether there was enough income or outgo but on whether Congress acted responsibly if the projections showed there wasn't going to be enough revenue. There has been a lot of stomach acid generated over the topic, but so far the Congress has always acted responsibly. The purpose of the projections is to show whether Congress needs to get worried and start acting responsibly again.

Mr. SEIDMAN. Bert Seidman, AFL-CIO.

On what I think is a somewhat different note, I would like to ask you to indicate what you think are the most important aspects, features, problems of Social Security that relate specifically to how it can be dovetailed with some kind of a supplementary program, whether it is private pensions or a supplementary program for Government employees or whatever it may be.

Mr. **Thompson.** The most important problem?

Mr. **Seidman.** Well, the most important aspects of it for that purpose; in other words, building a foundation for the rest of the discussion from your point of view.

Mr. **Thompson.** It is the benefit formula. The challenge in pension design is to produce a reasonable pattern of total retirement earnings replacement. I would argue that the Social Security formula was designed to serve a certain social purpose and not designed to be a social statement on how total retirement benefits should vary as career preretirement earnings varied. I would argue that pension integration should be expected. Other people can argue about how much integration is expected, but I believe that at least some integration is expected. Indeed, I believe that the Social Security benefit by itself for a low wage Government employee exceeds what he would get under Civil Service retirement. There are some winners even among career Government employees from coming under Social Security.

The other tricky thing is that Social Security is so portable. It is a benefit based on lifetime earnings. All pensions are designed to cover your service with a particular employer, but most people have worked for some other employer at some point in their career. That makes it very difficult to design your pension so that it works well for a real full career employee plus it also works well for somebody who has only part of his career under your pension system.

Mr. **DelQuadro.** Dave DelQuadro, Congressional Budget Office. I understand that the Social Security trust fund is going off the budget. Could you explain what that means in terms of the Government paying interest on the assets and if, in fact, the assets would remain in U.S. Treasury issues?

Mr. **Thompson.** The law passed in 1983 provides that in 1992 Social Security goes off budget. That would mean, as I understand it, that the payment of interest on the Treasury securities held in the trust funds would be a general revenue payment shown in the budget to the trust funds which are off the budget. That is my assumption.

Mr. **DelQuadro.** So given this projection of balances building up for over the next 2 decades or so, that means that there are going to be more and more assets for future benefit commitments, consequently the Government will incur larger and larger outlays as a result of the interest payments to the operating account?

Mr. **Thompson.** Well, what is your assumption about the balance in the rest of the budget?

Mr. **DelQuadro.** Isn't this just an additional——

Mr. **Thompson.** No. What taking it off budget does is that if Social Security were running a $20 billion surplus—it isn't doing that today, but that is what the numbers look like in the future—if Social Security were running a $20 billion surplus and the unified budget as we know it today were running a $200 billion deficit, when you moved Social Security off the budget the unified budget would have a $220 billion deficit. You no longer would be able to offset part of the deficit with the Social Security surplus.

Now how much debt has to be issued? In both cases $220 billion—$200 billion to the public and $20 billion to the Social Security system. Whether or not the Social Security system is in the budget, it gets $20 billion in debt issued to it if it is running a $20 billion surplus. The total increase in outstanding debt is $220 billion; the increase in the debt in the hands of the public is $200 billion and the increase in the debt in the hands of the trust fund is $20 billion. It does not make any difference whether Social Security is in the budget or out. What happens to the aggregate debt is the same; therefore, what happens to the aggregate interest payment on the debt is unaffected. However, as long as Social Security is inside the budget, those interest payments are a wash in the budget.

Mr. **DelQuadro**. I appreciate what you are saying, debt held by the Government would decline and the debt held by the public would increase.

Mr. **Thompson**. No.

Mr. **DelQuadro**. The total debt would remain the same. The gross national debt would remain the same, there will be a relative change in the mix, that held by the Government versus that held by the public and the Social Security off budget fund. What happens to the deficit in terms of the outlays going off to Social Security?

Mr. **Thompson**. The deficit is $220 billion because the Social Security surplus is no longer netted against the deficit, but to finance the deficit you have to issue $200 billion in debt to the public just as you would if Social Security were in the budget. Why only $200 billion? Because you get $20 billion from Social Security when the surplus there is given to the Treasury. The debt in the hands of the public is unaffected.

Nothing real happens when you move Social Security off the budget. The budget numbers change, but that is just a bookkeeping change. Now, it is true that people respond to bookkeeping numbers. But, abstracting from that, nothing real changes in terms of how much money is borrowed from the public, how much total interest is paid on the national debt and so forth. You are just shuffling around the accounts.

Mr. **Greenough**. Bill Greenough of TIAA.

Would you comment on the use of the trust funds as an economic stabilizer? For a long time we talked about the great development of unemployment compensation, Social Security and so on as a protection against what happens in depressions. Then in 1972 and 1983 we had a situation where the general economic situation was bad, but Social Security reserves were worse, and we had to do an emergency job on Social Security taxes to finance the program. Most economists would consider that the wrong way to proceed. But the idea of Social Security as an economic stabilizer has kind of dropped out of the discussion, and the 2 or 3 months contingency fund in Social Security seems to be accepted as appropriate without taking the business cycle problems into account.

Mr. **Thompson**. Yes. Right about the time that people got sophisticated in their discussion of automatic stabilizers, the balance in the trust fund fell to a level where the fund could not play its role. We used to talk in the late 1960's, and through the mid 1970's, about having a balance in the fund equal to a year's worth of benefits. That would be the target so that when a recession came you didn't have to raise taxes; you just drew down the balance in the funds and you had an automatic stabilizer.

What happened? The funds got so low that there was no choice but to raise taxes or else make a fundamental change in the way the system was financed. I would argue that for good reasons Congress decided that it was less painful to raise taxes than to make a fundamental change in the way the system was financed. Off into the future I suspect that if the funds ever get rebuilt to levels anything like what the projections call for in the 1990's, then that can happen again. Once again we would be in a position where it would be possible to draw down the funds rather than raise taxes and let the funds act like an automatic stabilizer.

Mr. **Walter**. Thank you very much. It has been a very good discussion.

Mr. **Thompson**. Thank you very much.

Mr. **Walter**. Jamie has a question.

Mr. **Cowen**. Jamie Cowen, with Senator Stevens. A couple weeks ago in The Wall Street Journal there was a column written by a member of the staff in the Congress regarding the expected surplus in the Social Security fund and the dire economic consequences that would result. I wonder if you have any comments on that.

Mr. **Thompson**. Yes, I read that.

There are views on both sides of that issue. It was only about 10 years ago that Marty Feldstein wanted to build up a huge surplus in the Social Security account as a way of increasing savings in the economy. The effect of the buildup in the Social Security trust fund really depends upon what is happening in the rest of the budget. If the Congress chooses to run deficits in the rest of the budget that are equal to the surpluses that are in Social Security, there will be a large accumulation of Federal debt in the Social Security trust funds but the impact on the economy is no different than if you just ran a balanced budget every year into the future. You are just borrowing from one Government account to finance another Government account.

So the economic impact is very hard to tell. Whether you want more savings or you are worrying about the Government buying up all the capital in the country—no matter what your fear is, whether it is one side or the other—it is very hard to say what is going to happen if you are only looking at the Social Security trust fund. Whether or not Social Security is on budget, it is still just one part of the Federal Government operations, and you can't tell what its effect is going to be unless you also know how the rest of the Government will be operating. Social Security could accumulate funds equal to 25 percent of the Gross National Product with little effect on the economy if the deficits in the rest of the budget offset Social Security surpluses. It is hard to tell.

Mr. **Walter**. Mr. Thompson, we thank you for getting this program off.

I want to try to move this along. I dare say we will before the afternoon is out return to some of the questions that you have started us on.

The next speaker who is going to present the first of two overviews—this one, Coordinating Pensions with Social Security (How It Is Done Today)—is Charles Ginsberg from Alexander & Alexander where he is the Manager of Research and Technical Services for the Human Resources Management Group. He has been in this business now in the employee benefits area for some 18 years as a lawyer and a consultant. He graduated with a B.A. degree from Johns Hopkins and a J.D. degree from the Columbia Law School. Charles E. Ginsberg from Alexander & Alexander.

II. OVERVIEW: COORDINATING PENSIONS WITH SOCIAL SECURITY (HOW IT IS DONE TODAY)

(Presented by Charles E. Ginsberg, Manager of Research and Technical Services, Human Resources Management Group, Alexander & Alexander, Inc.)

Mr. **Ginsberg**. I think I share Mr. Thompson's fear that I am bringing coals to Newcastle here. I see all these professionals and to describe integration in 15 minutes and get all the details in, it is sort of impossible. So what I would like to do—and since it is right after lunch, I don't want to put people to sleep—is just go over the highlights and just content myself with defining integration, generally describing the types, the variations, and mention some of the added little complexities that make this fun and then conclude with some notes on the studies that have been made on the prevalences and practices regarding integration.

To qualify for certain tax advantages under the Internal Revenue Code, a retirement plan can't discriminate in favor of a highly paid employee. A nondiscriminatory plan in general provides benefits for the highly paid that are the same proportion of compensation that is provided for the low paid as long as they have the same years of service. So, for example, if an employee makes $10,000 a year and gets a $4,000 pension, then the man who makes $40,000 a year should get only $16,000 in pension.

Integration simply means that the Government recognizes that the employer is paying some part of Social Security benefits and is allowing that employer to take credit for it so that we look at the total retirement benefit in determining whether a private retirement plan discriminates.

There are two types of integration. One is implicit integration where the plan itself does not mention the Social Security benefit. The employer merely provides a plan that has a lower benefit because he recognizes that Social Security will provide something. We are not concerned with that here although there has been one study to my knowledge that indicates that plans that do not take into account Social Security generally provide lower benefits.

Explicit integration provides benefits that specifically take into account Social Security. Integration has been around since 1936 but without formal rules until 1942.

There are three basic kinds of integrated plans. One, the excess plan, and there are two variations on that. One is the pure excess plan where the employer simply provides some benefit over an integration level and nothing below. There is a step rate Social Security plan where the employer provides something above the integration level and some smaller amount below the integration level. There is the offset plan where the plan's accrual of retirement benefits is the same for all employees and that is offset by a percentage of Social Security.

There is a recent development which has not caught on to any great extent and that is the cap program where you set some standard or set a replacement ratio percentage of final pay, for example, and then you try to meet that both through Social Security and through the private plan. This has some problems because it does not meet many of the IRS rules for integration at this time, but because of its simplicity there is some movement to maybe substitute this for the complexity of the old rules.

Within the pure excess and the step rate excess, there are two further variations. One is the flat benefit plan that provides a flat benefit for employees who have more than 15 years of service without regard to years of service. For example, an employee who has more than 15 years might get a benefit of 30 percent of pay over the integration level.

The unit benefit program provides a percentage of compensation for each year of service. There is a further variation on that. It may be based on career average or it may be based on final average pay, 5 consecutive years out of the last 10 or the last 5 years of service. IRS in its rules provides a different differential, meaning the amount that can be provided over the integration level is greater when you have a career average plan than it is if you have a final pay plan. If you average pay over less than 5 years, you have to reduce your differential.

To further complicate matters, if you have ancillary benefits, preretirement death benefits, disability benefits, postretirement death benefits, early retirement benefits, that exceed the actuarial equivalent—all of these things will reduce the differential that you can provide in your plan.

The offset plan provides, as I said, the same rate of accrual at all levels of benefit and then it is offset by some percentage of Social Security. A bare bones plan can offset the plan by only 83⅓ percent of the Social Security. If you use an earlier Social Security law, then you can use a higher percentage but you end up with a lower offset. The most common offset at this point is approximately 50 percent. Again there are two types of offsets: One is a flat percentage offset, and the other is a unit credit offset in effect giving credit for each year of service. You also have to produce that if you have an ancillary project under an ancillary plan.

Finally, in terms of prevalence and practice there are not that many studies that give us answers as to what employers are doing out there. The universe in each of the studies varies, the questions asked vary. It is very, very difficult to make any generalizations but I am going to make a couple anyway.

There are three surveys that I am aware of that cover large plans. There is a Bankers Trust survey, a Hewitt survey, and a Hay Huggins survey. They show that approximately 90 percent of the Fortune 500 size plans were integrated. In almost all of these are defined benefit plans. Several other surveys had a mixture: Hansen and Congressional Research. Their figures seemed to show with one aberration that somewhere over 50 percent of the private plans were integrated. When you got down into the small plans—and there were only two surveys, one by ASPA and one by the National Associates—you again came up with something over 50 percent of the plans being integrated.

Now the problem is that in some of these smaller plans it is difficult to tell when you have a defined benefit plan and a defined contribution plan. In the public plan area very few plans have been integrated in the past, probably for several reasons. One, many of them were not subject to Social Security. If they did become subject to Social Security, the plan had already been designed before that and only recently have cost factors been important. Now there are four public plans that have been recently integrated—New York, Delaware, Maryland and one other—so we may see more of that.

Social Security benefits are still in some of the studies to see what kinds of plans, what kinds of integration are used by these plans. Again, in the large Fortune 500 type of arrangement—by a 2 to 1 margin in two situations and by just over, I guess, 5 out of 8 margin in the other—they favor offset plans which are simpler to explain to employees and you know immediately when the law changes what the effect is going to be on your plan.

Approximately a third of those plans were step rate excess plans and in those plans very, very few—in one survey no plans—were pure excess plans providing nothing below the integration level. In the Bankers Trust surveys the four plans that did provide pure excess plans also provided other benefits for those employees who were affected by it. In the Hansen survey, which did not differentiate by size, they also showed that 80 percent of the integrated plans were offset plans, only 19 percent were step rate plans, and only 1 percent were pure excess.

In looking at studies on small plans, only a very few were offset plans; the majority were step rate excess plans and a larger percentage were pure excess plans but still a very small percentage of the whole—19 percent, 16 percent, and 15 percent. In my experience with a law firm and with small plans of professional corporations, I saw a great many more pure excess plans than I have ever seen in working with large corporations.

With public plans, those few that are integrated, there is a difference between the two surveys. One survey shows that offset plans predominate. Another shows that step rate plans predominate. In both cases the pure excess plan is very, very seldom used.

The major problem with our current system of integration is the complexity of it. Right now we have two more presentations to be made: one on the issues, the other on the options, and I won't get into that but something has to happen and I know that IRS is concerned about the complexity of it. It is concerned about the controversial nature of whatever they do on it, but I am convinced that within the next 5 years or so there is going to be a real change in the integration rules.

Mr. WALTER. Do we have any questions?

Mr. KEITH. I would like to ask a question.

My name is Hastings Keith. I am a retired Congressman, and cochairman of the Public Employee Pension Systems Committee.

You mentioned that very seldom were public plans integrated. There are quite a few Federal plans that are publicly integrated. TVA is an outstanding example. All the PX's—those so called nonappropriated fund agencies for the most part are integrated. To show you the importance of it, TVA, which integrated in 1956 or 1957 I believe it was implemented, froze the Social Security offset at the then level of I believe $21 or $31 a month and so it is really a perfect example of how not to do it in some respects because it makes a 2 percent difference at least in payroll costs, the fact that they only made a token Social Security offset. But there is another one that did even more devastation to the Nation's budget—to our own economy if you will—and that is the military pension. They didn't offset but just added Social Security on top of the military pension.

So we have examples of how not to do it completely, how to do it in a half-way fashion, and we have good examples such as perhaps the Federal Reserve bank employees or some other examples in the nonappropriated agencies. We have wonderful examples to look at and I would appreciate it if you would comment on what I have observed here.

Mr. GINSBERG. I think integration is going to come to public planning. I think you have mentioned a couple of examples. I was citing surveys that didn't mention those specifically, but I think the whole area of integration has to be looked at and revised. My personal feeling is that we should look toward the cap.

Mr. KEITH. Well, that is no startling observation. Bill Greenough made it 15 or 20 years ago and Tilove made it 25 or 30 years ago, and Massachusetts has been reading those books and ignoring them for centuries.

Mr. GINSBERG. But the fact that people suggested it 20 years ago and it has been ignored does not mean they were not good ideas then or now.

Mr. WALTER. Ed Jayne, Senator Bingaman.

Mr. JAYNE. I wonder if you would just comment generally on what are the pros and cons for choosing one type of integration over another, especially in terms of how they have developed? Maybe then we can tell a little bit more about what is going to develop in the future.

Mr. GINSBERG. With the offset plan it is very easy to tell your employees what they are going to get. You tell them what the benefit is and they know what the deduction is. The disadvantage to that is the fact that they know that their benefit is going to be reduced by something that they think they are entitled to anyway. In addition, you didn't have to keep amending your offset plan in the past—you still don't—because it just automatically took into account changes in the law. Up until very recently that was not true for the excess plan. I think the excess plan is much harder to explain to your employees.

Mr. COWEN. I have a follow-up question to what Ed just asked. We are going to be designing legislation that is going to be one of the largest, if not the largest, staff retirement programs in the country, and the administration of that program is going to be critical. Unlike a private pension, unless there is a collective bargaining agreement, we would find it far more difficult to change the plan since it would require a legislative change. I am just wondering if you could make some comments about which types of formulas are more easily administered and flexible to change. In other words, what would be the things that the Government should look at in a new staff retirement plan?

Mr. **Ginsberg**. I am not sure we have good examples in what we have already because with the complexity it makes it awfully difficult to go along with the changes in the law. I think what I look for is some overall change in the integration system.

Mr. **Cowen**. But assuming no change in integration, we at the staff level are beginning to design some options that are nothing permanent but some things to look at. The final forum, for example, is going to consider a few options of how to design a retirement program and we have to deal with the integration rules as they are now. With that as a given, what do you have to say? What kind of advice would you give as far as trying to administer the program as simply as possible?

Mr. **Ginsberg**. I am not sure I can give any real advice on that. My personal feeling, and I know there is disagreement, is that it is easier to administer an offset style plan just because it flows automatically with the changes in the law.

Mr. **Jayne**. As someone who is not terribly familiar with what the IRS rules are and why they have developed, I was wondering if you could comment just generally on those rules?

Mr. **Ginsberg**. What they tried to do back in the beginning was to determine what the value of the Social Security benefit was and then they figured the whole Social Security package was worth about 150 percent of the primary insurance amount and then they decided how much the employer would pay him for that, and the numbers have changed over the years. The assumptions have always been controversial, they change and vary. The numbers they have come up with are those based on what they perceive as the value of the Social Security benefit.

Mr. **Seidman**. If I am not mistaken, collectively bargained plans are predominantly not integrated, which is not to say that they are negotiated in a vacuum. People are well aware of the fact that there is a Social Security payment and that is taken into account in determining what the level of the pension is along with the condition of the firm and the industry and so on and so forth.

My question to you is, what is wrong with that system? It seems to me that it is a system which takes account of the existence of the two forms of retirement income but it does not tie it down to any formula, it is a lot easier to explain to people and it allows for flexibility in terms of decisions that are made with respect to the distribution of the total retirement income dollar.

Mr. **Ginsberg**. Well, presumably that is a form of implicit integration where you are taking into account that there is some other form. In your negotiations you are not asking for as much and there is nothing inherently wrong with that.

Mr. **Thompson**. From my perspective I think what you outline is perfectly appropriate in most collectively bargained situations because you tend to be dealing with a work force which has very similar wage levels. You are not dealing with a work force which combines people at the GS-1 level with people at the SES level where you have a wide range of wage levels. When you add a constant fraction to all benefits produced by the Social Security benefit formula, you end up with vastly more than you can defend as wage replacement for a low wage worker while at the same time the high wage worker has fallen way short of maintaining consumption standards or something like that.

Mr. **Seidman**. Well, sometimes that is taken into account. You have a different system for the higher paid employees which is integrated than you do for the lower paid employees and you might have to do that in a situation that you are talking about.

Mr. **Ginsberg**. Well, one of the issues in all of these areas is underpensioning or overpensioning and there are different schools of thought as to whether you provide a higher rate. There are fixed costs that you have as a worker that you no longer have as a retiree so the question of whether you need to provide that much of a higher replacement ratio for different people is one that is debated all the time. That is one of the issues I think we are going to get into later.

Mr. **Chang**. Yuan Chang, The Travelers.

I think we are getting close perhaps to the real issue. There are a number of social premises for integration with different formulas and at different levels. What I would like to hear from the speakers, at the risk of sounding somewhat naive, is why integration at all, or to go to the other end of it, why not 100-percent integration?

Mr. **Walter**. I think everybody wants a shot at that one.

Mr. **Ginsberg**. Why integration at all? One is the cost factor. Do you want to provide more benefits at direct cost to the employer when you know that he, the employee, is going to get money from the Government from this other system? There are other things you can put your money into. I think——

I will just leave it at that. I won't.

Mr. **Walter**. Keith, do you want to comment?

Mr. **Goodell**. I will address that later.

Mr. **Walter**. Jamie or Ed, do you want to give your judgments on that?

Mr. **Thompson**. I think integration is like the earnings test, in that there are a lot of different objectives to be served by the current Treasury rules. If you say, all I care about is having rational structure replacement rates, I can see how you end up with 100-percent integration. But in the process you also end up with a situation where some employees get nothing from their pension or alternatively they feel they get nothing from Social Security. I think there is a feeling that that is not fair, that everyone deserves a return on his Social Security taxes and everyone deserves some sort of return on employer pension plans. So you try to strike a balance.

As I said earlier, I am not sure that zero integration is defensible. At least, I don't find it a very defensible approach when you are dealing with a work force that has a wide range of wage levels. On the other hand, I find it a perfectly reasonable thing for a union to do.

Mr. **Walter**. I am inclined to move this along now and introduce the next speaker because he is keen to try to answer the question. I'll check first to see if there are other questions.

Yes, ma'am.

Ms. **Benson**. Helene Benson, Professional Managers Association.

Do all of the integration formulas, from the point of view of the employee who keeps changing jobs, do all of them just take into account the Social Security benefit earned with that employer or is it possible that each one takes into account the whole Social Security system?

Mr. **Ginsberg**. Yes.

Ms. **Benson**. Which? You mean each one takes into account all the entire Social Security, that is, work as well with as other employers?

Mr. **Ginsberg**. Yes.

Ms. **Benson**. Well, that is not integration.

Mr. **Ginsberg**. It is under current rules. Yes, it is possible.

Mr. **Walter**. On that note that those are the current rules, it is now our pleasure to ask Manuel Castells to speak to us. He is with Kwasha Lipton where he is in charge of one of three groups that make up Kwasha Lipton's actuarial division. He has served as a consultant to a number of the country's major companies and has been very active in areas of employee communications and in computer applications as they relate to employee benefit plans. Mr. Castells is very active in the professional actuarial community, a fellow of the Conference of Actuaries in Public Practice, a member of the American Academy of Actuaries and the International Actuarial Association, and an associate of the Society of Actuaries.

We have a professional actuary. Manuel Castells, we are pleased to have you with us.

III. OPTIONS: COORDINATING PENSIONS WITH SOCIAL SECURITY (THE OFFSET INTEGRATION APPROACH FOR DEFINED BENEFIT PENSION PLANS)

(Presented by Manuel F. Castells, Partner, Kwasha Lipton)

Mr. CASTELLS. The reason that I was putting my hand up at the beginning of that last question was that a lot of what I am talking about really goes directly to this matter. The question of "why integration?" comes up. The theory of integration is fairly simple. All you are trying to do is coordinate Social Security and other plan benefits so that in total they provide a more reasonable level of retirement income. This is necessary because Social Security provides for benefits that are very high on the lower portion of pay and nonexistent on the higher portion of pay, the part of pay above the Social Security wage base. They have a tilt that most people would not consider reasonable in terms of the total retirement income that both the pension plan and the Social Security should provide. Thus, integration will allow the sponsor to come up with a reasonable level of retirement income, including everything but personal savings which is very difficult to include in such a calculation, and further it will allow the employer to at least partially level off the tilt of the Social Security benefit towards the lower pay by providing for an opposite tilt, shall we say, on the pension plan benefit.

I had a few comments in the area of current integration practice but most of these have been gone into already. There are a couple that I felt may have been passed over a little quickly, and one is implicit integration and there was a question from the floor on that before.

With regard to this, in fact, probably the vast majority of negotiated plans are not directly integrated, and probably the vast majority of them, however, do reflect in the formulas that they are attempting to achieve through the negotiation process benefit levels that recognize the fact that Social Security is a large component of retirement income for the people on whose behalf they are negotiating. Unfortunately, unless a group is fairly similar in its income levels, this kind of a plan—a plan that does not integrate directly—has a hard time providing for benefits that end up being reasonable for all employees.

A more extreme case of this was present in a lot of union plans before which didn't relate the benefits to earnings, that provided for benefits to be a flat dollar amount for each year of service, that kind of thing with maybe a maximum recognized service. There even a partial recognition of income level was left out. Many more union plans have moved in the direction of at least recognizing earnings levels with regard to pension plans even though they still do not integrate directly.

With regard to the other point about the current practice that I just wanted to mention, and this ties in with the last item, is that the statistics that were quoted on percentages of plans that were integrated—the statistics that were saying that 90 percent plus of the plans of major corporations and certainly more than half of most plans are integrated directly—apply only to salaried plans and with good reason. The salaried plan is where the vast differences in income levels appear. A lot of the hourly plans are not directly integrated because it is just plain not necessary to do so due to the similarities of earnings levels.

Getting down to the legal requirements presently in place with regard to qualified plans, you start off with a legal maximum for a plan that does not have employee contributions or where employee contributions are the same below and above the Social Security wage base of 83⅓ percent, and what this represents is 50 percent of the 1971 value of the total Social Security package versus the value of an age 65 benefit.

Back in the late 1960's the total value of the age 65 benefit plus the ancillary Social Security benefits was estimated by IRS actuaries and they came up with something like 167 percent, something like that, of the age 65 benefit. And the employer half of that was 83 percent and so they said if you have a bare bones plan that provides only age 65 benefits or that provides other benefits but charges for them on some sort of actuarial equivalent basis, then you can offset from the pension formula 83⅓ percent of the Social Security benefit if the employee has been with you 15 or more years. Most plans first of all do not offset anything like the 83⅓ percent, most plans offset 50 to 60 percent, and second, most plans only offset 50 to 60 percent for a career person. They may choose 30 years as a career, they may use 40 years as a career. They might offset 1¼ percent of Social Security for each year of service—a number like that is fairly common.

In other words, even though legally you can offset up to 83⅓ percent of the Social Security benefit if the employee has been with you 15 or more years, in practice it just does not occur and therefore should not be really addressed.

The other thing that was really not talked about in these integration rules is something that quite likely would apply on any plan that is designed for Federal employees, and that is the possibility that because Federal employees are contributing to Social Security and they also currently contribute fairly heavily to the Federal retirement system, perhaps contributions on the Social Security cover part of the wage base would be either lower or nonexistent.

Now in a private plan under present rules with regard to integration, a difference between what is contributed under the Social Security wage breakpoint and what is contributed above the Social Security breakpoint allows you to increase the offset. So a plan, for instance, that required, say, 6 percent contributions above the Social Security breakpoint and nothing underneath which might end up costing the employee similar amounts to what he is presently spending in total counting Social Security and the retirement plan, would under current IRS rules with regard to integration quite likely be allowed to offset 100 percent of the Social Security benefit.

I think we can fairly quickly go to that as being sort of an automatic place you should be looking at; that is, the 100-percent offset as the beginning model here. Then you get down to the questions of, well, what are the problems of 100-percent offset. Maybe you want to pro rate for short service. Maybe you want to make other adjustments because of peculiarities of the present Federal program that you may want to preserve, but to a very large extent we have an environment which has been while not totally free of Social Security fairly free of Social Security and now Social Security is being brought into the picture. The simplest way of looking at it is adjust your contribution rates to reflect this and use 100-percent offset.

Let's continue with private plans. Presently we are living with rules in private plans that were designed 15 years ago before the tying of benefits to inflation, before a whole variety of changes. We are also living with rules that tie things to ERISA which ties private pension plans to age 65 retirement, while Social Security is going to be moving up to retirement at 66 and 67, soon enough that it actually affects me and I think of myself as old enough that it shouldn't.

The rules that apply to the private pension programs are going to have to be changed in the near future. They are going to have to be changed because of the dramatic changes in Social Security benefits that have occurred since the rules were put in place; they are going to have to be changed because of the lack of tie-in between ERISA and Social Security in terms of retirement age. Since they are going to be changed, the question is in what direction? The present rules while perhaps theoretically correct 15 years ago—and I don't think they were—today are totally not correct; they are very, very complex and just have not stood the test of time. As Social Security has changed, the rules have not been able to be left alone without them becoming totally inapplicable.

So suggestions are coming up now in terms of what kind of changes should occur. A lot of people have been discussing a reduction in the complexity of these rules by talking about the total value of all Social Security benefits and then taking half of that against the main retirement plan benefit, the age 65 or normal retirement benefit. Instead of valuating each benefit provided by Social Security—be it disability, be it early retirement, be it a widow's or survivor's benefit of some sort—and determining what is the employer's share, the maximum offset should be set at 50 percent.

I hasten to get back to the fact that I don't think that private plans which are typically noncontributory and structured a certain way for a lot of historical reasons should be the guide for a public plan that again, for a lot of reasons, typically has been contributory. They are very, very different and while perhaps it makes sense to look at the total employer cost between average private plans and public plans and say that these cost levels ought to be similar, attempting to tie in on detail by detail just does not make a lot of sense. So even though I think that the most commonly proposed thing in terms of changes in integration is to simplify and perhaps aim more directly at that 50-percent level for integration, that does not really necessarily make any sense at all when you tie it to the public plan area.

You do get into some problems though in terms of the public plan area if you start talking about the 100-percent offsets. You get into the problems of people with breaks in service, with gaps in earnings that, you know, what do you take 100 percent of? Do you take 100 percent of a theoretical full career benefit? Do you then pro rate it? How do you handle it? What about people whose income maybe goes up and then down; there are not that many people like that in government but there are some. How do you reflect that in terms of—I mean you might have some contributions to make to the plan by the employee and now he does not get anything because 100-percent offset more than eliminates the pension. Perhaps it ought to be minimums. Perhaps those minimums ought to be related to the amount contributed. There are a variety of elements here that just need to be addressed.

Next, what about the fact that if you have 100-percent offset that ends up being more than 100 percent of the benefit for, say, the low paid and the middle income people, if the benefit formula wound up such that Social Security is higher than the Federal program which would be the case currently for very low income people, shouldn't there be some provision to handle this?

In other words, shouldn't there be some minimum level of benefit provided. But you are starting to talk about details, you are not talking about the overall big picture. The big picture needs to address all sources of employer provided or assisted benefit, needs to look at preretirement income versus postretirement income for career people, and needs to do so on a posttax and postemployment cost basis and get down to the nitty-gritty of replacement ratios and the adequacy of various replacement ratios at the lower income levels versus at the higher income levels where perhaps additional personal savings could be expected to exist.

Thank you.

Mr. SEIDMAN. You got down to the point that I was going to make at the very end of what you were saying and that is, it seemed to me that you were implying that somehow or other the same replacement rate at all levels is what is "fair" as you have stated in your paper. That is a very controversial question. I think that you can make a very good case for saying that some kind of a progressive benefit structure, taking account of both Social Security and the supplementary pension, is what is fair. This is not the time or place to discuss this but we ought not just to assume that that is a given. You qualified it slightly at the very end but I would qualify it a great deal more.

Mr. CASTELLS. Well, I would think in the private retirement community most people that advise corporations and so forth would agree that not only should you reflect taxes—which of course are progressive and therefore provide for more of a cut in pay for higher paid people than for the lower paid people. Not only should you reflect that which goes in your direction but further that the feeling of using a higher replacement ratio after adjustment for taxes for the lower paid is reasonable because there is the availability of supplementary income for savings that certainly grows as an employee makes more money.

Mr. **Walter**. Jamie.

Mr. **Cowen**. I think after these three presentations it is too bad we can't repeal Social Security coverage of Federal employees. But be that as it may, I do have a question and that is—I think everybody would agree—that this integration issue is extremely complicated. Why, though, don't other corporations and major businesses instead approach the subject by providing an add-on plan with a thrift plan to compensate the higher income employees and avoid all the integration complexities? Is there some reason that they don't use that approach?

Mr. **Castells**. Well, many companies in fact do have add-on plans and it is just a different name for integration. One of the integration methods that is discussed both in my paper and the preceding paper was that of the excess or step-up plan. Essentially what that does is it says let's provide a basic plan that is adequate for people whose wages are generally covered by Social Security as a base plan—and that might be 1 percent of final pay for each year of service—and on top of that let's provide an extra half of a percent or three-quarters of a percent but only on pay over the Social Security wage base.

Mr. **Cowen**. There is still a problem with that because the Social Security base is changing all the time and as I said before, you would have to change the plan by legislation. What I am saying is, for example, let's say you provide a plan which grants a straight 1 percent of pay per year service for everybody and then just provide a thrift plan or something like that for anybody who wants to contribute and the employer provides some matching. Won't this approach resolve the integration issue in a simpler manner? Why is that not more prevalent?

Mr. **Castells**. Well, first of all let me answer your first comment which was that the Social Security breakpoint changes every year. Most private plans are structured so that they tie in with it and you don't have to change the law; that is reflected in the then current Social Security pay bases.

In terms of providing for a different type of benefit on pay over Social Security, that is something that very few companies do. I think you were really kind of mixing up two approaches. The one approach is to say we will have a 1-percent pension plan on all pay for years of service and then—I am going to give the more complicated one first and then the simple one—and then let's have a savings plan and you know that 6 percent that you paid to Social Security, well, on pay over Social Security you can put it into a savings plan and we will match fifty cents on a dollar, a dollar on the dollar or something like that. There are not very many companies that do that, but theoretically it makes a lot of sense. Not only does it make sense in terms of getting the dollars to the right people, but it also makes sense in terms of encouraging the people that are going to have to be short changed in terms of the benefit formula replacement ratios to save their own money to get there.

The main reason that the private sector has not done that traditionally is that that 6 percent of employee money that would go into the plan up until recently would not be—and even now perhaps could be with difficulty—pretax money; it would be posttax money. Now the employer contribution, on the other hand, was pretax money and so it didn't make sense to require the employee to put in posttax money if instead you could put the entire thing with pretax money that came from the employer.

Now the other possibility, if I might, was the first part that would be available to everybody and you say again a 1 percent plan for everybody, and for everybody who wants to save money there will be some sort of matching. That is a bit of a scatter approach since most compensation for most companies is under the Social Security breakpoint, and so the cost of providing benefits that you feel are appropriate for your higher paid by offering to subsidize the benefits for all levels and hoping that the lower paid don't take advantage of it is just too expensive.

Mr. **Smith**. Harry Smith, Sun Company, Inc., Pennsylvania.

Another response to Jamie's question, "Why doesn't the industry be sensible, and develop simple, practical, easily understood plans?" is simply that we, in industry, are caught up in our history of plan development. Things like how we react to old laws and regulations, and old collective bargaining. The truth of the matter is we probably know exactly how a good, new plan should be designed.

If you think that integration is complex today, think of the complexity you are going to have if employees can say, "Hey, we are going to have an intellectually clean pension plan." And, Jamie, you have this opportunity today, and I hope you use it more wisely than it has been used in the past.

The whole thing goes back to corporate plans. Integration is simply coordination of various sources of retirement income. You can make it as complex as all you actuaries want to do it but this is all it is. You can determine your income replacement goals. Get an engineer with a slide rule and he will help you.

Mr. **Castells**. I think in that case get an engineer that does not have a slide rule.

Mr. **Greenough**. On this one I would like to give an unambivalent and clear answer. I think what he has proposed at this point, and I know they are thinking about it, is clearcut. I love the phrase "an intellectually clean plan" for public employees. Why not? That is a good idea. But the possibility of solving the dichotomy between a defined benefit plan and a defined contribution plan is encouraging. Usually the arguments go back and forth between defined benefit and defined contribution plans, and we get nowhere.

The key thing is that with Social Security not quite adequate, it would make sense to have a defined benefit plan to bring that level up to adequacy on the Social Security base, and as a matter of fact throughout all salary on a defined benefit plan basis, clean and clearcut without any step rates, without any modification as to Social Security bend points, etc. Then on top of that to have a defined contribution plan with contributions from the public employees with a matching contribution from the Federal Government, on a pretax basis applied to employee contributions.

Employee contributions should never have been taxed in benefit plans. The distinction between employer and employee contributions for tax purposes is of no interest to any economist, but it is of great interest to the tax people and that is too bad. So, exclude from taxable income the employee contributions and have a defined contribution plan for the public employees both below and above the Social Security maximum wage. Also, employees should be able to put in voluntary contributions above those normally called for by the plan. I think it deserves great and careful consideration as a way to go for the Federal plans.

Mr. **Castells**. I think you leave off the possible need for some additional benefits over the Social Security level unless you are overpensioning under the Social Security level from the Federal plan itself. I just don't think that you can leave that totally as a scatter approach where anybody can contribute.

Mr. **Greenough**. I didn't say voluntary. What I was trying to say was that you have your defined benefit plan under and defined contribution plan over the Social Security base, but it is a regular plan with required contributions from both employer and employee, neither of them currently taxed but all of them with deferred taxes. Then beyond that you should allow individuals to contribute voluntarily to a plan that can be as generous or as nongenerous as you want but not related to "needs or adequacy in retirement." It is just an add-on individual savings arrangement and you can dispense with that without destroying the main argument.

Mr. **Young**. Harvey Young from Metropolitan Life.

I address this to Jamie. Are the same complex IRS rules that are necessary to make sure that the Federal tax dollars are subsidizing benefit costs properly for the private sector also necessary for the Federal plan? Might you not seek statutory relief from such constraints?

Mr. **Cowen**. Well, that is part of the reason the Civil Service system is under attack now, because it is isolated in the public's eye as something special. I am not speaking for anybody but myself but one of our desires is to try to draft a plan that is comparable in its structure to a private plan so that it cannot be isolated.

Mr. **Young**. I agree, but that comparability does not necessarily have to include all the complexities that have been inherited.

Mr. **Cowen**. That is right.

Mr. **Castells**. On the other hand, I think we like to see whatever simplicity is allowed to the Federal employees come over into our field as well.

Mr. **Walter**. Jamie indulged there a little bit in the royal we, "speaking just for myself, it has been our view."

Mr. **Bittkau**. Manfred Bittkau, United Auto Workers.

Jamie's question was very interesting to me because the plan that was described is exactly what the largest auto companies in fact do with their employees. They have a negotiated benefit base plan and then at a fixed level in the past, and now still substantially below the Social Security level, the contributory program begins. The benefits are based indirectly on the earnings because they are based on a percentage of the contributions made and as such there is no integration involved because this treats everybody equal, and there is a base plan in effect which, in fact, brings about the income level that has been sought by the negotiated contract for the hourly workers. So when that level is accompanied by Social Security, it makes for a sounder and stronger base. Then above that it thins out somewhat, which is an acceptable system of doing it. You find that in many of the large companies.

I think that is exactly what you are describing. Why can't it be done?

Mr. **Cowen**. The question remains, does that base plan covering the auto workers cover everybody in the corporation or in the business?

Mr. **Bittkau**. Yes, basically it covers them all. The plan negotiated for is equal to the plan for those that the plan was not negotiated for so therefore they could never at that point in time say we did less for them. Then subsequently something happens which is not available to the hourly worker and that is the purchasing of the additional retirement income. Generally the entry level has been put far below where Social Security stops, because you can appreciate that $20,000 or thereabouts is not yet the level for all salaried employees. In fact, 6 or 7 years ago there was a great revolt of their nonorganized workers when they proposed to raise the entry level by several thousand dollars because suddenly 25, 30, 40 percent of the workers could have been completely excluded from this contributory plan. They kept, of course, what they had in there but it would have taken them possibly years to come back in again. Therefore the need, that you are concerned about, to constantly make changes could be somewhat ameliorated by the fact that you set the entry level regardless of what happens for a period of time. Then a review process is added at which time, if required, there can be brought in a new entry level again that does not exclude too many people without being so far below that you are stacking the benefit too generously.

Mr. **Castells**. I think that you brought into the discussion something that we have finessed around before. In an inflationary environment and in the environment where there is a tilt in Social Security benefits even under the covered wage bases, merely using a breakpoint where a benefit is available for people that are over the full Social Security pay bases—that is, $35,000 or something like that—is probably not enough and most integrated plans will not do that. Most integrated plans that are on a step-up basis, which is what we kind of moved over and talked about that most of the auto plans end up at, will not use 1 percent of pay up to $35,000 and then 2 percent or 1.5 above $35,000; they will pay the higher percentage at an intermediate level that might be calculated by reference, say, to average Social Security breakpoints, that kind of thing. They might be between $15,000 and $20,000 or say half of the current Social Security breakpoint or some multiple Social Security benefit. It varies according to the plan, so you are typically not only talking about people making $40,000 or $50,000 that might need some degree of supplementation over and above the basic program.

Voice From the Floor. Perhaps you would be better off—instead of looking at the current complexities—to go, as several speakers have suggested, into more of an intellectually clean plan. The key issue still comes down to what you want as to income structure. Now that seems to me the hardest one to decide on but that is the compromise to reach.

Mr. **Walter**. As the agenda for the day makes clear, we have now an Issues and Complications part of the program with Keith Goodell of United Technologies and John Fleming from the Bakery and Confectionery Union.

I am inclined, unless someone raises his hand violently in opposition, to take a few minutes break and to return here at let's say 3:20, 15 minutes from now. We will start up promptly.

[Whereupon, a short recess was taken.]

After Recess

Mr. **Walter**. I think what I am going to do is introduce both of our final speakers at the same time; that way no one has any kind of claim on my giving a longer introduction to one party or the other.

The next speaker is going to be John Fleming who is the Administrative Director of the Bakery and Confectionery Union and Industry International Health Benefits and Pension Funds, a position he has held for some 21 years which I believe probably makes him a friend and acquaintance of a great many of you in this room. He is also a teacher of pension design and pension plan design at GW.

Keith Goodell here on my right is with United Technologies in the Connecticut office where he is Manager of Actuarial Services, with several years with a benefits consulting firm prior to that, and earlier with a major insurance company. He is a Fellow in the Society of Actuaries and an Enrolled Actuary.

"Issues and Complications" is Jamie's phrase to wind up the program, so I am not sure which person gets to do the issues and which gets to do the complications but whichever way you work it out the next speaker is John Fleming.

John.

IV. ISSUES AND COMPLICATIONS

(Presented by John Fleming, Administrative Director, Bakery and Confectionery Union and Industry International Health Benefits and Pension Funds)

Mr. FLEMING. Thank you.

Good afternoon and welcome back.

I am afraid that several of the previous speakers have stepped on several of my lines but I am going to go through them anyway. I would like to explain starting off that although this is an attempt to be balanced, I am in no way a spokesman for the Bakery, Confectionery and Tobacco Workers Union nor a spokesman for the labor movement generally. I am a neutral observer, if you will, of at least the multiemployer aspects of the private pension plan world.

As Administrative Director I serve a joint board of trustees. There are eight union trustees and eight employer trustees, and my role is to carry out administratively the ministerial functions that are assigned to me by that board of trustees, so in my remarks please don't infer that I am speaking in any way for either the union that is the sponsor of the plan that I work for or for the labor movement in general.

The remarks I prepared are somewhat different than the tone that has been taken here because I tried to do like that justice statue and have a blindfold on as regards the forthcoming legislation which must be written relative to the new employees of the Civil Service system. I confine my remarks generally to what we have encountered in the private sector. I think Mr. Smith implied in his remarks that what we hope to do by this exposition is reveal to you all the good things but also warn you about all the pitfalls, and hopefully in the design of the new program you could take those things into account.

I would like to explain to you just a little bit about our pension fund, our Bakery and Confectionery fund, at least as far as structure. We have presently something in excess of 30,000 pensioners on our roles and we cover about 100,000 bakers throughout the United States and Canada for pension benefits. The assets of the fund in the past fiscal year just exceeded a billion dollars and our funds are 87.5 percent fully funded. I bring that to your attention only because further on in my remarks I will be referring to a problem that evolves out of unfunded liability.

To start off I would like to review where we are in the private pension industry. I just ask you to consider if you would the billions of dollars per month that are paid out to pensioners now on the roles of private pension plans. The good that that has done, the human dignity that that has given those pensioners and the ability to live in at least a relative degree of comfort was unimagined back in the 1920's and the 1930's; but try to think if you would for a minute about what our economic situation would be and what our society would be if we didn't have those billions of dollars flowing into the economy because it serves two purposes quite obviously.

Not only does it provide that dignity that I spoke about for the pensioners, but in addition to that it is pumping billions of dollars a month into our economy just on the benefit side alone, never mind the capital accumulation. It also helps to fuel our economy. So while I will talk here about some of the problems that we have and some of the pitfalls we have encountered while we have those, I would hate to conceive of our society presently without that private pension system in effect.

I want to dwell on four major issues that I perceive from the seat that I sit in as affecting the multiemployer area, the collectively bargained area and the entire pension plan area itself. Those four major issues—and it is interesting what has occurred here earlier today—are the control of the funds and the investment of the funds, whether it should be a defined benefit or a defined contribution plan, whether integration with Social Security should occur or nonintegration, and whether or not a plan should be contributory or noncontributory.

I give attribution to Dan McGill through his textbook, and Allen, Malone and Rosenbloom in their textbook have helped me enormously in what I am doing; EBRI in its research has helped me and of course our own actuaries have helped as well. For purposes of convenience and to try to review these issues, I have broken down the pension world or the pension history into three different areas, and the areas that I have used arc pre-1949, 1949 to 1974 when ERISA came in, and then what we have experienced since ERISA has been in existence.

Before 1949 the types of plans that were in existence were company plans, mostly company plans, which were set up by the company at the goodwill of the company and were managed exclusively by the company. However, there was a limited amount of coverage in terms of the numbers of people. There were not millions of people covered by pension plans as there are today. The Railroad Retirement System, however, was in effect during that era, the pre-1949 era, and I don't know if there is room to fit a history of that system into these deliberations, but I do think it would be worthwhile because it is a rather unique system where private employers paid into a system through a government-controlled mechanism which provided their retirement benefits and I think it might be helpful in your further deliberations.

Of course before 1949 the United Mine Workers had already been actively bargaining for pensions and had created a multiemployer pension fund. Let's look at that period of time as far as issue number one, the control of the investments and the rules and regulations of the plans. Those were the exclusive domain of the employer who was the sponsor of the plan. They contained such things as bad boy provisions which meant that if you were disciplined you could lose your pension. They meant also if you went to work for a competitor you could lose your pension. There was a whole series of things which were based on the principle that the plan had been established out of the largess of the employer and therefore it was up to him to determine for each individual whether that individual had gained their pension.

The pension plans additionally, and I think we should keep this in mind, were set up voluntarily by those companies and they were not subject to the pressures that are presently in our society which cause companies to set up plans. They set them up simply because they felt that they were the right thing to do.

The second issue as far as defined benefit or defined contribution plans: They were generally defined benefit plans although there were certainly contribution plans in existence, but generally they were defined benefit plans. An interesting thing that I have come across during this research is that the first regulation in the Internal Revenue Code dealt with profit-sharing plans rather than pension plans. Pension plans were not dealt with in the Code until several years later.

On issue number three, integration or nonintegration, the original regulations on integration, as was noted here by one of the speakers, came out in 1942. You will remember benefits under Social Security began to flow in 1940 and the original integration rules were written shortly after Social Security became effective. I find it of interest that Social Security was written in such a fashion as to tilt in favor of the lower paid employee and the integration rules were then written to tilt it back again. I don't find any problem with that, but it is interesting that the Federal Government should have written these two pieces of legislation, one to tilt the thing in one direction and then the other to tilt it back. It is not that simple. There are good philosophical reasons for the integration rules, but the fact is that one tilts it in one direction and the other in the second direction.

The fourth issue that I thought we should explore is the contributory versus noncontributory. Many of the plans in existence before 1949 did provide for contributions, but I have not personally been able to develop statistics or secure statistics that would indicate to me whether that constituted a majority of the plans in effect. My guess would be that the majority of the plans were noncontributory but that is a simple guess, and if any of the experts here can give me any guidance on that, I would appreciate it; it would make the next talk easier or more definitive anyway.

Post-1949: In 1949 the Supreme Court decided in the *Inland Steel* v. *United Steelworkers of America* case that pensions were bargainable, and from that point forward because of the way the law is written if the employer sat down at the bargaining table, he had to take into consideration the granting of pensions. Nothing in the law said he had to give a pension, but the law did provide that it had to be bargained for and right about that same time, or at least by the time it was able to get geared up, the Korean conflict came along and a wage freeze was put into effect, and in the first two wage freezes that this country has experienced each time Congress or the Executive, whoever made that decision, overlooked fringe benefits and so fringe benefits were not included in that freeze.

As a result of those two things, the *Inland Steel* case and the Korean wage freeze, they acted like swinging doors for the explosion that then occurred in the creation of private pensions in the early 1950's. That growth in the early 1950's continued on right through the 1950's and well into the 1960's.

Another very interesting thing that occurred coincidentally with this was that in 1947 the Labor/Management Relations Act was amended to be the Labor/Management Relations Act of 1947—it was commonly called the Taft-Hartley Act—and I think anybody would agree that the political thrust of that was to slow down collective bargaining. The Wagner Act, its predecessor, had encouraged bargaining and it was the feeling in the Legislature that that had gone too far, and so Taft-Hartley was written in order to slow the process down; but within the Taft-Hartley law they spelled out the framework for multiemployer funds.

John Lewis had already written his pension fund in the coal mines and so he had what was known then as a preTaft-Hartley type plan, but all multiemployer plans formed after that were called Taft-Hartley plans. To me it is very interesting that a law that was written in order to slow the process of collective bargaining provided the framework on which the multiemployer funds that we know today were based.

Let's go through the issues then if we can in that post-1949 era: the control of the funds and the investment of the funds. The possibility of Taft-Hartley funds made it feasible to establish craft-wide pension funds on a local or regional or a national basis, and indeed several are international. Some of you might not be familiar with this but it is an interesting thing. I was in the union movement I guess for several years before I understood why a union was called an international—it is because they represent people in Canada as well, just as we do, in the B.C.&T. So some were international in scope as ours is and they covered the crafts in Canada as well as in the United States.

The investment of the funds that resulted was the responsibility of a joint board of trustees composed of union trustees and employer trustees, and so the control of the assets of the plans was in the hands of two groups who had to find a way to reconcile their differences and make their investment rationale based upon that reconciliation. The methodology was particularly appropriate in the construction trades where there were small employers who could not economically provide the same pensions as a large trust could. The large industrial unions—the steelworkers, oil workers and so on—negotiated the benefits and terms of the plans or the terms under which the benefits were to be paid, but the management of the assets was left in the hands of each individual employer. We will get back to that when we get into our next era.

On the second one, defined benefits or defined contributions—the plans which fall in the two categories that I have been talking about, multiemployer plans and collectively bargained single employer plans—for the most part were universally defined benefit funds. On integration or nonintegration of Social Security, unions in their collective bargaining posture have strongly resisted integration and continued to do so to this day. I don't know of a single multiemployer fund that provides for integration although some probably do exist. The vast majority of negotiated single employer plans with which I am familiar also do not contain any provision for integration. Now there, I am sure some exist but generally they do not.

On the issue of contributory or noncontributory, again multiemployer plans had resisted any form of individual contributions. In single employer, collectively bargained plans the unions also resisted individual contributions, and again I am sure that there are areas where contributions are provided for but in the vast majority of instances there are no employee contributions to those pension plans.

That spectacular growth of the pension plans continued through the 1950's, as I said, and on into the 1960's, and as you can expect, any such growth and the paucity of legislation or regulation that was in force created abuses to the system. The abuses crept in and legislation was proposed for many years to bring those abuses to a halt. The first report that I recall that proposed reforms within the private pension system was a report made to President Kennedy back in 1961 and upon his death it was turned over to President Johnson who, for purposes of his own, perhaps simply because of other priorities, shelved it and nothing much happened.

Ultimately in 1974 we ended up with ERISA which marked the end of one era but unmistakably created a whole new era of its own. There seems to be a principle that proposed legislation grows rather than condenses by the time it is finally written and that principle certainly was carried out by ERISA, because by the time I received a copy on my desk there were 278 tightly packed pages of legislation.

What happened then after ERISA? Well, let me get to how ERISA got there first if I may. Perhaps the single most publicized event leading to ERISA was the collapse of the Studebaker Company and the concomitant collapse of the Studebaker Employees Pension Plan, and that takes us right to issue number one, the control of the funds and the investment of the funds.

One of the cornerstones of ERISA was the "prudent man rule." In the Studebaker situation the company had elected to invest the pension funds in the company itself so that the portfolio was full of Studebaker stock. When the company collapsed, the portfolio of the Employee Pension Plan was worthless and those employees after many years of work for the company had no benefits whatsoever. Since that time there has been an even stronger feeling, I believe, on the part of unions. In a position paper that the Industrial Union Department wrote some 2½ years ago they have gone on record to advocate that where possible, the control of pension funds be shared equally by union and management which presently exists in the multiemployer field.

On the second issue as to whether it should be a defined benefit or a defined contribution plan, another feature of ERISA was the establishment of the Pension Benefit Guaranty Corporation, the PBGC. That insurance has protected tens of thousands of participants who would otherwise have lost their pension plans because their individual pension plan failed. More recently there has been a law called MEPPA, the Multiemployer Pension Plan Act, that was enacted to provide the same protection to multiemployer funds through the use of a different mechanism. The mechanism that is used in multiemployer funds is called withdrawal liability. The provisions of ERISA have caused plan designers to take a very hard look at their plans.

A defined contribution plan does not participate in the PBGC scheme and thus the costs and the reporting requirements are eliminated.

In addition to that and very important, and growingly important I am afraid, the unfunded liability does not exist in the defined contribution plan because the only obligation on the part of the employer is to set the money aside. If the money goes south, that's not his responsibility; if the investment turns sour, that is not his responsibility. All he has done is promise to put the money aside and then hopefully the investment of that money will provide some benefit, but just from its terms, not a defined benefit.

As a result of that, the employer in the defined contribution plan has no unfunded liability. He does not have to meet any past service promises which have been made, and when this gets down to how you show this on your books, the AICPA right now has a proposed rule that says that any unfunded liability which you have, and you can only have that if you were a defined benefit plan, has to show on the balance sheet of the company. At the very least apparently it is going to show up as a footnote in the financial report. That has caused a great deal of concern on the part of employers, and you can understand that concern, if the balance sheet goes to a stock analyst and the stock analyst sees a high number called unfunded liability. If he is not acquainted enough with pensions, he is going to think that that company is in worse shape than the company who simply has a defined contribution plan, so the clash there is a very, very real one.

Because of those reasons there has certainly been a favoring of defined contribution plans on the part of corporations even though those plans contain weaknesses as far as the participants are concerned. It is my belief that unions will continue to resist defined contribution plans unless they are in addition to an already existing defined benefit plan. At the first session that we held here Bob Krinsky gave a paper in which he suggested that perhaps the issue is not defined benefit or defined contribution but rather a solid defined benefit plan acting as a base and a defined contribution plan above that to give leverage for improvements to be made.

Issues three and four—the other two issues we have talked about—have been exactly the same right across the three areas: whether or not contributions were going to be made and whether or not the plan was going to be integrated with Social Security.

Now I would be evasive if I did not include here a fifth issue which really is part of the first issue and is going to provoke a lot of future debate and disagreement, and that is the termination of overfunded defined benefit plans and the recapturing of the assets. I am sure most of you are current with that because it is currently being talked about. Senator Metzenbaum is just tacking on an addenda to every bill that goes through the Senate in order to try to get a moratorium on this technique, if not to halt it.

The principle is simply this. Does the money in the portfolio belong to the persons for whom it was contributed or if the promise has been fulfilled by the defined benefit plan, does money over and above the promise belong to the employer? I am not going to address where I stand on that issue but everybody should be aware it is a current issue that I feel falls in under the control of the assets. Because of the control of the assets of a jointly trusteed plan, I would have to presume it would be much more difficult to terminate that type of plan under those circumstances although I have heard people discuss it.

The industry goes on, with all of those pitfalls, with all those concerns, with the incredible exercises you went through on integration just before the break. I will tell you a funny thing about that. The class that I teach, we meet for 2 hours each week and we spend at least 4 hours just simply trying to comprehend what you have been asked to comprehend here in about 20 minutes. It is not easy.

There is an excellent book, by the way. EBRI, the Employee Benefits Research Institute, has just turned out a handbook for those of you who are interested in employee benefits and they cover that subject of integration in nine pages and they do it very, very well. They do it very thoroughly for the layman who just simply wants to understand the thing without trying to become a mechanic in the field.

The industry goes on, we have our pitfalls, we have our problems, but as I said in my opening remarks, I would not want to see our economy or our society without such an industry. I am confident that the format you have constructed here to consider all of the issues will be very helpful to you, I hope, not only in avoiding our pitfalls, but I am sure as well in rewarding the new Federal employees who will be the participants in the new plan.

Thank you very much.

Mr. WALTER. Keith.

I think what we will do is have Keith speak now and then we will have questions jointly to the two speakers and all the rest of the panel.

Keith Goodell.

Issues and Complications

(Presented by Keith J. Goodell, United Technologies Corp.)

Mr. **Goodell**. Good afternoon.

Being the last person on the program reminds me of my high school days when I was on the wrestling team. I was the heavyweight and I was always the last one on the mats. I might add that none of the spectators ever fell asleep or left the room before I was finished.

I am very grateful for the opportunity to speak this afternoon to present our views on pension integration and to discuss some of the issues involved in designing an integrated pension plan.

United Technologies Corporation is a multi-industry company with our major focus on four global markets—aerospace, building systems, electronics and automotive.

I would like to talk about our pension plans. To give you some background and put my further comments into context, in the United States we sponsor a total of 50 pension plans and we cover a few over 100,000 employees in those plans and also about 40,000 retired persons.[1]

Plan assets at the beginning of 1984 for the entire 50 plans have accumulated to over $3.5 billion and in 1983 we paid $160 million of retirement benefits. Our contribution for 1984 for these 50 U. S. plans will be about $203 million. We also contribute to another retirement program and that is Social Security. Our 1984 contribution for the retirement part of Social Security is $140 million. Our employees will contribute a similar amount in the aggregate and this is exclusive of our contribution to the Hospital Insurance component of Social Security.

The 50 plans that we sponsor can be categorized into those which are implicitly integrated with Social Security, those are generally plans that cover employees who are union employees, and plans which are explicitly integrated with Social Security, which generally cover employees who are not represented by a union.

This afternoon I would like to concentrate on the explicitly integrated type of plan. I would like to consider the characteristics of the largest UTC pension plan.[2] This one is explicitly integrated and this will allow us to look at some integration formulas and rules in practice as applied to our plans. This one plan among the 50 covers 33,000 employees and also 21,000 retired workers. The assets for this plan are $2.2 billion. This is the integrated retirement benefit formula; it is 2 percent of final average compensation for each of the first 20 years of service that an employee works at United Technologies plus 1 percent of final average compensation for years of service in excess of 20, integrated with 50 percent of the Social Security benefit that the employee would receive. So, for example, someone who retires with 20 years of company service would have a 50 percent final average compensation benefit offset by 50 percent of Social Security.

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[1] See chart p. 45.

[2] See chart p. 46.

Here are some examples of applying that benefit formula to various levels of income—lower, average and higher income levels.[3] The UTC pension and the Social Security pension are outlined here. You can see that the Social Security pension remains at relatively low levels for the higher income earners. Social Security benefits, as we have heard many times this afternoon, are better as a percent of pay for the lower wage earners. It was designed that way in order to meet the basic needs of all workers and we think that is entirely appropriate because the national social program should emphasize social adequacy.

The UTC pension program was designed with the goal of equitable benefits for all employees across the earnings range. Thus, we believe that a medium or higher paid employee should receive a benefit percentage from a combination of Social Security and our pension plan which is commensurate with the percentage for lower paid employees. Not exactly the same, but we have to take into account certain differences such as work related expenses, relative tax positions and amounts of disposable income. We have chosen in designing our plan to emphasize individual equity. When we apply the rules for integration, we find that we have produced a combined benefit percentage, or replacement ratio, which decreases as compensation increases; however, it does not decrease as fast or to the same degree as does Social Security by itself. In the chart, the blue line shows the replacement ratio of Social Security by itself over an earnings range and the top line shows the replacement ratio for the combination of Social Security benefits and the UTC pension plan.

I would like to review two major considerations for the design of an integrated pension plan.[4] The first step would be to set a benefit level that is sufficient to attract, retain and motivate good employees for the business. The benefits should be sufficient so that aging employees can retire with financial security but we must also look at the cost of the program. We review the cost of all the benefits or benefit improvements that we are contemplating incorporating into our plans and perhaps adjust the benefit level depending on the budget.

To get the appropriate benefit level, we really need to consider Social Security benefits.[5] If Social Security benefits are not considered, then one of two things will result. Certain employees will receive a very high combined benefit while others receive inadequate benefits or else the cost is going to be substantially higher than we could justify. This chart shows Social Security again in the blue line. For example, a nonintegrated pension plan which is a flat percent of pay plus the Social Security added. That is called the Low Benefits because the medium and higher paid employees tend to have a less adequate benefit than the lower paid. The other line called High Cost attempts to rectify that problem by raising the benefits for the higher paid but has the result that benefits to the lower paid become close to 100 percent and again the cost gets very high.

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[3] See chart p. 47.
[4] See chart p. 48.
[5] See chart p. 49.

UTC does not have an unlimited budget for the proper funding of our pension program, thus we cannot ignore the substantial benefits that our employees derive from the company contribution to Social Security. Integration with Social Security allows the most efficient benefit delivery for all employees from the contribution level that we have allocated. Now this particular point addresses Mr. Chang's question about why should we integrate in the first place and it is because doing that allows the most efficient benefit delivery for all employees, not just for a group but for a wide range of employees.

A public employee retirement plan which would be funded through tax revenue has the same considerations when the participants are covered by Social Security. A benefit structure must be designed to meet the requirement needs of a broad spectrum of employees and at the same time avoid an undue financial burden on the taxpayers.

Now let's turn to some of the issues.[6] I would like to consider the salary range for a group of employees to be covered by a new pension plan. If a very narrow range exists, then the Social Security replacement ratio is about the same for the whole group, and this is indicated by the light blue showing a group which happens to be in the $25,000 to $35,000 range of income. The Social Security replacement ratio is a relatively narrow percentage centering around 30 percent, and it is possible to determine what the target benefit percentage should be: subtract the 30 percent and that simply is what the benefit program can be designed to achieve.

On the other hand, if the salary range is wide, then proper integration can only be accomplished explicitly; that is, by directly mentioning the Social Security benefit in the pension formula. Some examples of that would be 50 percent of pay integrated with 50 percent of the Social Security benefit at retirement. Alternatively, it could be related to service: 1.5 percent of final average pay integrated with 1.5 percent of the Social Security benefit at retirement for each year of service, maximum 35, for example.

Social Security benefits are calculated using earnings over the employee's entire career so when somebody comes to retire and applies for a benefit from the Social Security Administration, the records which are kept in Baltimore would consider all employment that the retiree had through his whole career. However, how much credit for Social Security benefits should a company take for somebody who is not a full career employee?

There are basically two ways that this can be handled. One is to calculate the Social Security benefit using only those earnings while in company employment. Alternatively, the Social Security benefits for a full career including all earnings could be calculated and then that benefit prorated on the actual service with the company from which he is retiring.

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[6] See chart p. 50.

UTC uses the first method in determining Social Security benefits in our integrated benefit formula. That is distinct from the full Social Security benefit he is going to receive, of course. We should note, however, that government regulations do not require private plans to produce any reduction in the integrated Social Security benefit when an employee has less than a full career with the company.

Another issue, what happens if the integration formula that is designed results in a small benefit or perhaps a zero benefit for lower paid employees? [7] One solution, of course, would be to increase the benefits for everybody; however, that is the expensive way. A better solution would be to establish a minimum benefit that would override the integrated formula. This slide shows again Social Security by itself in the blue and the combination of our pension and Social Security. The dotted line represents the amount of that combination except for the minimum benefit, and the solid line indicates the difference for that particular group because of the minimum benefits.

I think in private industry it just is not realistic to support a formula which produces a zero benefit, and that perhaps addresses the other part of the question that Mr. Chang had raised earlier. So an example of the benefit formula could be the 50 percent of the final average pay integrated with 50 percent of the Social Security benefit with a minimum benefit, however, of $10 or some flat dollar amount times years of service. Keep in mind that the minimum benefit would not be integrated.

One of the major issues in inflationary times is the relative role of Social Security and pensions after retirement.[8] None of UTC's pension plans contain an automatic increase provision for postretirement inflation. Such provision is expensive and is uncommon in large private plans. Instead, in periods of inflation a company often will award ad hoc increases to their current retirement group. This would help them maintain their standard of living at retirement. In fact, we granted an ad hoc increase in 1979.

There are three reasons why we have not given additional ad hoc increases. First, they are very expensive; second, Social Security benefits are fully indexed for inflation; and third, inflation has moderated. I should also note that at the time of retirement the pension benefit under a qualified plan is fixed and that any increases from Social Security inflation indexing do not result in a decrease under this or any other integrated pension plan in private industry.

It is interesting to note that a lower paid employee receives a larger portion of his total retirement benefit from Social Security than does a higher paid employee. Thus, the lower paid employee has a greater degree of inflation protection and is better able to maintain his standard of living at retirement. Higher paid employees with relatively less inflation protection are generally presumed to have other sources of financial security to help them maintain their standard of living.

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[7] See chart p. 51.

[8] See chart p. 52.

One other source in our case is our defined contribution savings plan. We support that in addition to our basic pension plan which I have been referring to earlier. This plan is viewed as a supplemental plan and it is a common plan where the company matches 50 percent of the employee's contribution of up to 6 percent. Assets accumulated at retirement will help improve our employees' financial security. In our situation the defined contribution plan is not integrated with Social Security.

With all the complex calculations for Social Security benefit determination that we talked about today, how can an integrated system be efficiently managed?

It is imperative to rely on a computer system for benefit calculations. The system must be reliable, efficient, and flexible. At UTC we maintain employment records for 60,000 employees on our data base system. When an employee is contemplating retirement, our pension technicians work interactively with the system to produce a pension status sheet. This provides a summary of all the benefits and options that will be available to him when he retires. The Social Security benefit is automatically calculated through a subroutine that has been prepared, installed, and is maintained by the actuarial consultant. The pension status sheet allows a retirement counselor to discuss accurate pension benefits with each employee nearing retirement.

Another very important part of the integrated plan, in any plan, is the communication of it to the employees. What are the considerations in communicating the benefit information? An integrated benefit formula has the stigma of being difficult to communicate. This is likely due to the negative connotation of the offset component in the formula.

The most effective way to tell an employee about his pension benefit is to give him a personalized benefit statement. UTC provides annual benefit statements to all employees who are covered by our integrated plan. Accuracy and clarity are absolutely essential. The data that we use is accessed from the same data base that is used for the record keeping purposes.

Our benefit statement shows the benefit that an employee is expected to receive at retirement from the pension plan and separately from Social Security. We concentrate on the results produced by the integrated benefit formula and not the step-by-step process in deriving those results. We want our employees to understand the total compensation package that we offer.

I would like to conclude by saying the pension plan integrated with Social Security is a highly efficient vehicle for delivering equitable retirement benefits, and proper design and management are essential for the success of the program. In the future as benefit design and financing questions arise, I would be very happy to discuss them with you.

United Technologies Corporation

U.S. PENSION PLANS

Number of . . .

● Pension plans	50
● Employees	100,000
● Retired members	40,000

RA957TX.013

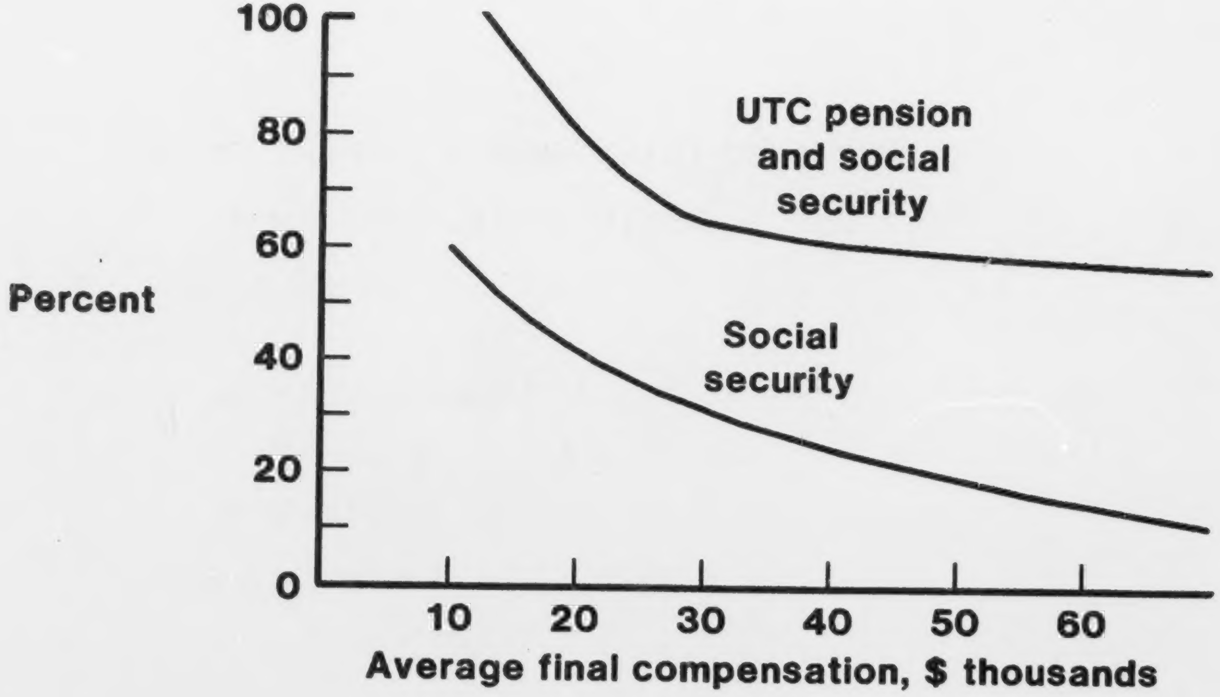
LARGEST UTC PENSION PLAN

Number of . . .	
● Employees	33,000
● Retired members	21,000
Plan assets	$2,200,000,000

Retirement benefit

- 2% x first 20 years, plus
  1% x over 20 years, integrated
  with 50% social security

RA957TX.012


Percent
100
80
60
40
20
0
UTC pension and social security
Social security
10
20
30
40
50
60
Average final compensation, $ thousands

RA957TX.008

MAJOR CONSIDERATIONS FOR DESIGN

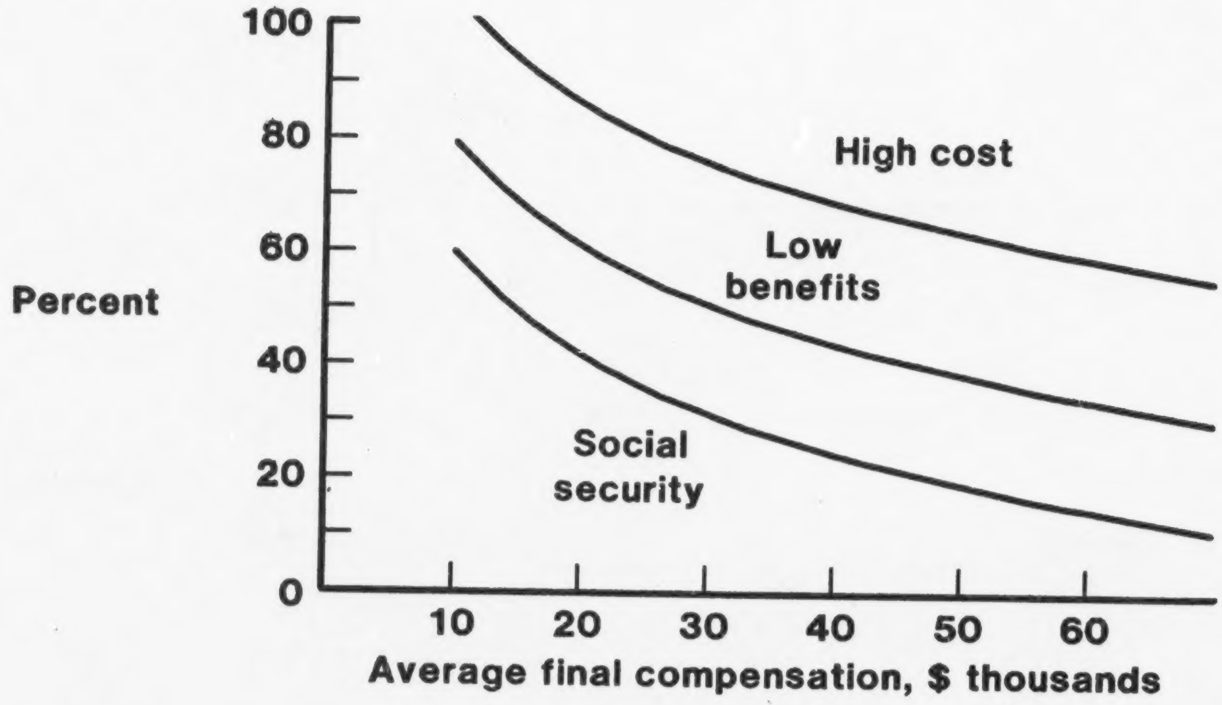
Benefit level

- Attract retain and motivate good employees
- Retirement with financial security

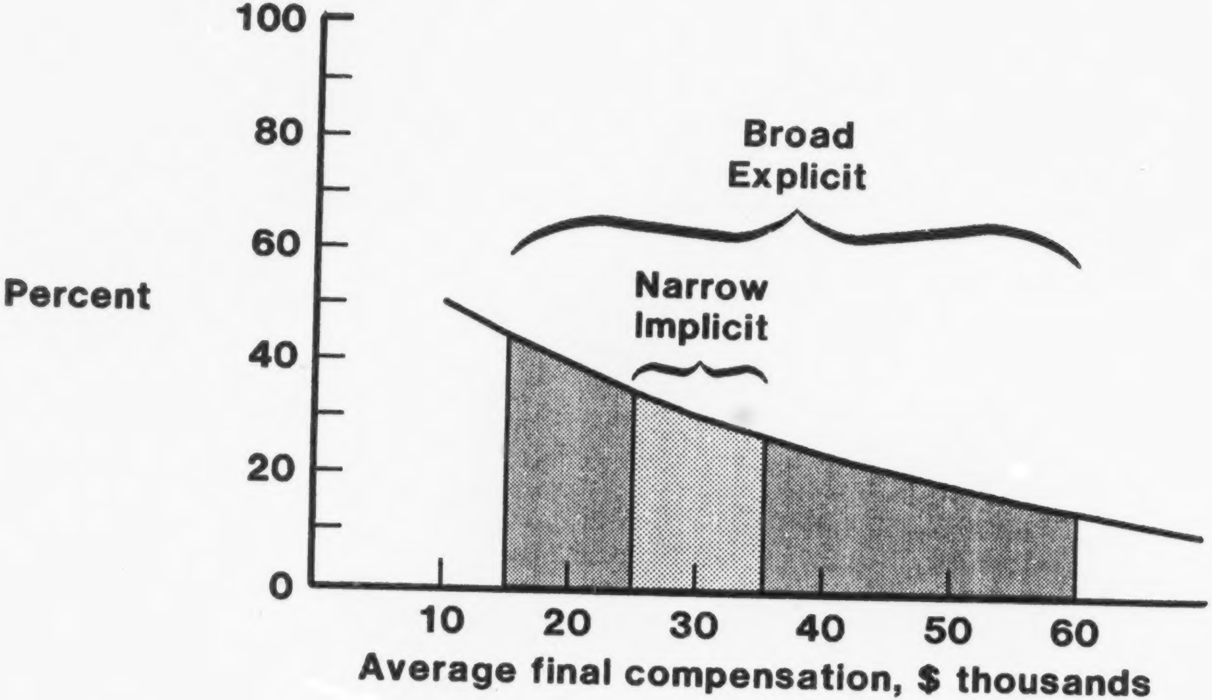
Financing

- Review cost of benefits
- Adjust depending on budget

RA957TX.009

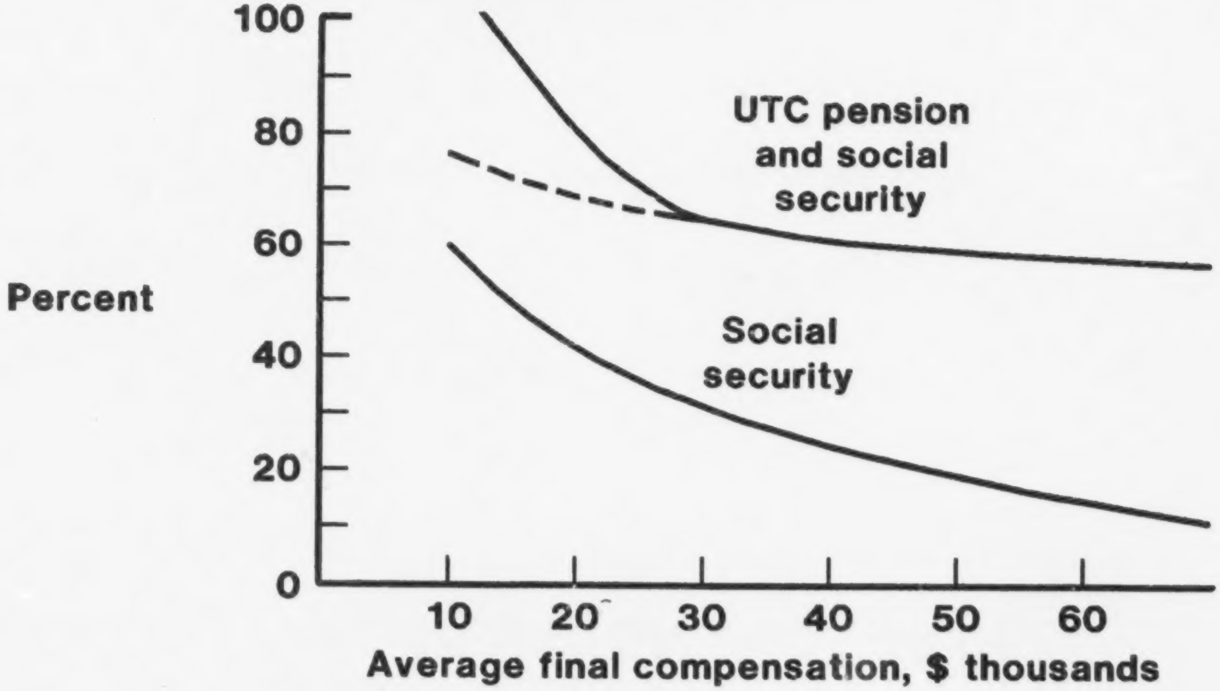

Percent
100
80
60
40
20
0
High cost
Low benefits
Social security
10
20
30
40
50
60
Average final compensation, $ thousands

RA957TX.006


Percent
100
80
60
40
20
0
Broad
Explicit
Narrow
Implicit
10
20
30
40
50
60
Average final compensation, $ thousands

RA957.004

MINIMUM BENEFIT



RA957TX.007

AD HOC PENSION INCREASES

- Expensive
- Social security is indexed
- Inflation has moderated
- UTC sponsors a savings plan

Mr. **Walter**. Yes, sir.

Mr. **DuBrin**. Harry DuBrin, New York State Teachers' Retirement System.

There have been a number of presentations and references to integration and I think in the presentations we made here at the last meeting there was the intent of those of us from our particular plan and also a representative of the United Federation of Teachers to identify some of the problems New York State encountered in attempting to integrate as a corrective measure, and the overall effort on the part of the Legislature and the Permanent Commission on Pensions to curtail costs that were emerging in rather large amounts in New York.

The plan that was adopted in 1976 was based on the assumption that we could, through integration, and in an offset fashion, develop a benefit that would achieve the kinds of levels of benefits that the public employees coming in after that point in time could expect, in sufficient amounts, to meet their economic needs on retirement. We ran into a number of problems with that and unfortunately in the discussions that we have had today we really don't know the scope of the plans that deal with integration.

Are the plans exclusively for a normal retirement allowance or are they including a disability benefit? If it is including a disability benefit, I submit that the offset method of integration, particularly in light of what has been happening in the treatment of Social Security disability benefits—the reliance on the review process—makes it difficult to achieve anticipated benefits. You see, we find that years ago while we were denying benefits, Social Security was granting them. In the last 5 or 6 years it is just the reverse. If we were required to integrate a disability benefit with Social Security, obviously that is going to create a problem in calculating the benefit.

So we ended up with two major problems. One was the ability to estimate effectively. As Mr. Scott identified at the last meeting, the Controller of the State of New York announced there have been a number of instances after the integration plan was adopted where benefits were just not available to the retiree on the offset plan approach. We had a number of meetings and task forces were created. We ultimately ended up last year adopting a plan in which we moved away from integration so I think that maybe one or two of the persons that have talked about integration as a desirable means of dealing with the problem, particularly perhaps in the public area, ought to just address the question of whether the plans that they have been advising have a built-in disability and whether the ability to estimate benefits has been effective. We certainly found them not to be effective.

Mr. **Castells**. Well, in most private plans estimated benefits are acceptable. I suppose I think you have two different problems here and maybe we should separate them. The first one is the calculation of the Social Security benefit, and most private plans will allow the calculation of the Social Security benefit at least on a preliminary basis to be done with estimating techniques. If the actual Social Security benefit is dramatically different, the retiree can bring in proof of his earnings that show this. Otherwise, the estimating technique is assumed to be proper and can be used.

That is not the case under your plan as I understand it. You are starting off with a system that has kind of the bases loaded against you. If you cannot use estimating techniques, then you are right, it is going to be very, very complex and for young people it is going to be quite difficult.

The second thing is the eligibility for ancillary benefits. Now most private plans again must use Social Security's final determination with regard to whether somebody is disabled or not and this is because under the private plan, the integration rules require it and so again we don't have that problem in the disability area.

Mr. **Walter**. Yes, sir.

Mr. **Garrett**. My name is Harper Garrett. I'm with Alexander & Alexander. Just to comment, Mr. Fleming in his talk noted some of the forces that had been working against or threatening defined benefit plans and one of which he mentioned was the recent accounting proposals. Just to comment there, we should understand that the Financial Accounting Standards Board is currently reevaluating their entire proposal and it is my very strong feeling that when the final accounting standards come out, they will be much less dramatic than what we have seen so far.

In addition, I concur with him that I think we will continue to see a very real future for defined benefit plans because they are, as we discussed in previous forums, the single best method for targeting in on what we-feel is the appropriate replacement ratio, whatever that is decided to be.

Mr. Fleming also noted that he really feels good about the growth of the private pension system and the fact that it is there. I concur in that and I would just say that I think a very real reason for that growth has been the Social Security integration rules, as imprecise as they are, because without that, without the ability that has enabled employers to target appropriate and equitable replacement ratios, we would not have as large a private system. I agree with what Mr. Castells has said that Social Security integration provides the employer with a very fine way to achieve appropriate replacement ratios.

Mr. **Walter**. Do we have any responses to the comment?

Yes, sir.

Mr. **McGrath**. James McGrath, Prudential Insurance Company.

Mr. Fleming in his paper said that he believes that unions will continue to resist defined contribution plans unless they are a supplement to an already existing defined benefit plan. I wanted to ask him if he has seen any pressure among, for example, the younger members of the Bakery and Confectionery Workers Union toward the implementation of a supplemental defined contribution plan.

Mr. **Fleming**. Yes, we have. There is no doubt about it. When you start talking about the 401(k) and you put it into magazines and you put it on the TV and do those sorts of things, the younger person is going to want to know if he can get some override which is the way he views it. I have never heard a proposal to do away with the defined benefit but I certainly have had younger members who have become very interested. I attribute most of it to magazine articles but nonetheless, yes, I would have to say, yes, we do find that interest there.

Mr. Walter. Yes, sir.

Mr. Ruddock. Andy Ruddock, National Association of Postal Supervisors.

Mr. Goodell, are the employee contributions for your savings plan pretax or after-tax dollars?

Mr. Goodell. The savings plan has an option, which is what we call the 401(k) option, and the employee can choose to contribute on either basis.

Mr. Ruddock. Which approach do the majority of the employees prefer?

Mr. Goodell. 401(k).

Mr. Ruddock. Thank you.

Mr. Keith. In your display about the Social Security and the retirement plan, you didn't list your 6 percent that you had for 401(k). What about the final statement when you leave the firm, at what time do you bring that into play? On the statement how much benefit do they get at time of retirement that they are given or how much they have accumulated from year to year? There was no mention of your 401(k) or other plans.

Mr. Goodell. That is right. I was addressing the basic retirement benefit. This is focusing on the issues of an integrated plan and using integration so I just focused on the benefit statement style. Actually we don't have green candy-stripped computer paper but we do address retirement benefits.

Mr. Keith. You showed, if I recall correctly, a very substantial figure of—I should say it was about 10 percent of your cost for your retirement plan to supplement Social Security.

Mr. Goodell. I am not sure.

Mr. Keith. In your opening statement you talked about the amounts of money spent for Social Security and the amounts of money that you spent for retirement plans.

Mr. Goodell. The contribution for the 50 plans is $200 million and the contribution that the UTC makes for the employee group to the retirement section of Social Security is 140.

Mr. Keith. So it looks as though you were putting about 10 percent of your payroll into the retirement plan.

Mr. Goodell. That is correct.

Mr. Keith. And the other 6 percent is on top of it?

Mr. Goodell. No, we don't contribute 6 percent to the savings plan. We contribute up to 3 percent when an employee contributes up to 6 percent.

Mr. Keith. So that would then be another——

Mr. Goodell. Up to 3 percent in fact including the expense of administering the savings plan. I think that the cost of the savings plan is a little over 2.5 percent.

Mr. Keith. So you get to a total cost of retirement plan on the company's part of 6.3 percent roughly for the Social Security, 10 percent for the retirement plan and 1.5 percent for the supplemental retirement plan for a total of about 13.5 percent—no, 20.5 percent would be your total cost of payroll?

Mr. Goodell. That is right. I am not sure of the math there but it is 5.4 percent for the retirement benefits of Social Security and of course that really covers about 90 percent of payroll so that is, say, 5 percent plus 10 plus 2.5—17.5.

Mr. **Keith**. 17½ percent.

Thank you.

Mr. **Walter**. Yes, ma'am.

Ms. **Barber**. Jean Barber, OPM.

I am interested in the same problem that the gentleman from New York raised about the Social Security benefit, especially if you estimate it on an annual statement. I was wondering if you get any arguments from your employees based on what you put on that statement and how much data do you have to have about their employment history before they came to you before you can make an estimate that they will accept.

Mr. **Goodell**. I don't work with the statement so I don't know. I suspect that we minimize the arguments and the questions because we attempt going through in a very positive manner the way it is derived, because there is a negative connotation in the offset. So I think generally it is a well-accepted and well-endorsed plan by the employees who are covered by it.

Second, we have a data base that goes back to the formation of the plan as it now stands integrated through the offset style of formula which first started in 1978. We began at that time the salary data for the recordkeeping system. The records were held in a different way before that time so we have salaries for the group covered back to 1978, and in compliance with the recent revenue ruling we back-average salaries before that time at 6 percent.

Ms. **Barber**. But you don't have data on their employment under Social Security before they came to your company? Because, of course, that would contribute to their Social Security.

Mr. **Goodell**. No, because we don't use that. One of the issues I think is whether a company should take into account all of the years' earnings of an employee even though that employee worked for the company for only the last 15 out of 30 years. Current rules allow that to happen. We talked about that earlier. UTC does not use the full earnings for periods of time before the employee is with UTC in computing the offset component. Therefore, the result is that we are more liberal with the employee because instead of taking away, using an updated formula, his entire Social Security benefit, we are using only that portion that he earned while he was with UTC, a smaller amount. A smaller amount results in a larger benefit.

Mr. **Cowen**. Keith, when you take into account all of the administrative costs due to the retirement plan that you have and computing Social Security and the thrift 401(k) plan, what is the percentage of payroll, would you say, allocated to administrative cost of this whole thing?

Mr. **Goodell**. It is a very small portion. If somebody were to divide $1 million by $3 billion, that is about it.

Mr. **Keith**. What is the total value in terms of dollars of your other fringe benefits? How much of your pay includes such things as group insurance, hospitalization and sickness?

Mr. **Goodell**. Of course addressing the retirement benefit and Social Security aspects, our contribution there is the $200 million plus the $140 million that we talked about. As far as group insurance—that is, medical and life insurance and disability which are separate items—I think that is about $250 million. That has gone up dramatically because of the cost of health insurance and it seems to be continuing to climb in spite of our cost containment attempts.

Mr. **Keith**. Do you remember what your cost for disability insurance is because if it is a separate and distinct item, we would have a better way of comparing it.

Mr. **Goodell**. I don't know that.

Mr. **Walter**. Well, before I let you all go I have a couple of notes from Jamie. One of them is to remind you of the next, the fourth, forum in this series. I announced the date earlier in the day and it is the forum on Pension Funding, Investment and Administrative Issues. The speakers will include Irwin Tepper from MIT; James A. Curtis from Milliman & Robertson; Kenneth Keene from Johnson & Higgins; Jon Fossel from Alliance Capital Management Corporation; Gerald Facciani who has spoken here earlier today from Professional Plan Administrators in Cleveland; and Charles Tharp, Executive Director of the Pension Benefit Guaranty Corporation.

That will be May 30, a full day. From 9:30 to 5:30, a full day's meeting.

Second, on the table there is a list for names of those who would like copies of papers that are not available here today. There is a list where you can sign up to have papers sent to you.

In the committee prints on the first forum the only participants that are named are those of you who are members of Actors' Equity and took a speaking part. Those of us who sat quietly are not listed.

Finally, at the next session OPM will try to have available copies of its compilations of Civil Service benefits statistics, fringe benefit statistics. Jean Barber will probably say whether they are going to do better than try but I am sure she is going to have them here.

Ms. **Barber**. Printer willing.

Mr. **Walter**. Printer willing, the statistics will be here.

Jamie, thank you very much.

Ed Jayne is gone, I think.

Thank you all for being here and we look forward to the fourth session. Well done.

APPENDIX

SOCIAL SECURITY: HISTORICAL DEVELOPMENT AND CURRENT STRUCTURE, BENEFITS, AND CONTRIBUTIONS*

(By Lawrence H. Thompson)

I. Introduction

This paper describes the key elements of the U.S. Social Security system. The first section traces the development of that system from its beginnings in the 1930's through the most recent major modification in 1983. The next section outlines the major features of the system today. The final section discusses the current projections of the future financial condition of the program.

II. Development of the Public Retirement Income Program

A. THE SOCIAL SECURITY ACT OF 1935

The prevailing social ethic in the United States has traditionally placed a high value on self-reliance and self-provision, and this may help explain why the United States was one of the last major industrial countries to adopt a program of public social insurance. Social Security is the product of the Great Depression, the period in our history during which the ethic of self-reliance faced its most serious challenge. Yet the program's design reflects the continuing desire to preserve and reinforce the work ethic.

Prior to the Depression, the Federal Government role in retirement income security consisted almost exclusively of providing pensions for its own employees—mostly postal workers—and for veterans of the Armed Forces. The primary public sector role in caring for the needy aged was played by local governments and to some extent State governments, and traditionally this role was discharged through the operation of alms-houses and poor farms. Beginning in 1915, individual States began adopting programs offering cash assistance to needy aged residents. By 1930, of the 50 jurisdictions that are now States, 18 had some program of cash assistance for the needy aged; by 1935, 31 States had such a program.

During the Depression, millions lost their jobs and were forced to use savings accumulated for future retirement instead for support of their families. Others saw their personal savings disappear as a result of bank and business failures. The number of people who needed the assistance of others in order to survive grew enormously, and many who had never before thought they would ever need or accept government assistance found that they had no alternative. The political climate changed abruptly as the number in need of assistance greatly exceeded the ability of traditional State and local government institutions or of private charities and individual families to supply the assistance.

The Federal Government responded first with loans and then with grants to State governments to help these governments defray the cost of assisting the needy. When these efforts proved inadequate, direct Federal emergency relief programs were established. Nonetheless, by 1937 the government estimated that roughly half of the population over age 65 had essentially no independent means of support at all and were dependent entirely on their friends, relatives, and children.

In this environment considerable political pressure developed for the enactment of more permanent measures to assure economic security, especially for the aged, and to further relieve the fiscal burden on State and local governments. A number of fairly radical proposals began to gain substantial support across the country, and the response of President Roosevelt and the Congress was the Social Security Act of 1935.[1] This Act created a variety of new economic security programs.[2] Among the most important were two of the basic elements of the present retirement income security system in the United States:

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*Any views expressed are the author's own and not necessarily those of the U.S. General Accounting Office.

(1) A national program of needs-based benefits for the aged.

(2) The Old-Age Insuarance program that is the cornerstone of today's Social Security program.

The needs-based program, called Old-Age Assistance, was viewed as the Federal response to the immediate problem of income support for the needy aged. The precursor of today's SSI program, it was built on the pre-existing State programs. Under Old-Age Assistance, the Federal Government offered to finance one-half of the cost incurred by each State in operating a program of cash assistance for the needy aged. To be eligible for Federal sharing of the cost, a State program had to meet certain specified conditions, perhaps the most important of which was that eligibility be offered to all needy residents over the age of 65. Other elements were left to State option, including decisions about the level of benefits to be paid in each State program. At the outset, the Federal Government's only restriction on benefit levels was that Federal payments not amount to more than $15 per month per case.

The social insurance program, initially called Old-Age Annuities and subsequently called Old-Age Insurance, was viewed not as a solution to the immediate problem, but as the response to the long-range retirement income needs of the nation's aged. Under the program as it was enacted in 1935, no benefits would be paid at all until 1942. Monthly benefits were to be based on a worker's accumulated taxable earnings. Moreover, monthly benefits paid to the first retirement cohorts would have been fairly modest because persons reaching retirement age in the 1940's would not have worked under the Social Security program for a very long period of time, and therefore, would not have had the chance to accumulate substantial amounts of taxable earnings. Indeed, under the program as enacted in 1935, the maximum anticipated benefit levels would have been reached only for those workers reaching 65 in 1982.

One important feature of the 1935 Act was the method chosen to finance Old-Age Insurance. The 1935 Act provided that benefits would be financed entirely from a payroll tax with one-half of the tax to be levied on the employer and the other half to be collected from the workers in the form of deductions from their pay checks. Specifically, there was to be no government contribution from the general revenues. The exclusive reliance on payroll tax finance was a conscious decision made by President Roosevelt and the Congress against the advice of many of those who had worked to develop the various economic security programs contained in the Social Security Act. Apparently the President and the Congress felt that in a society which placed a high value on self-reliance and self-provision it was appropriate for workers and their employers to bear the entire cost of retirement benefits through their tax-contributions.

Another important feature of the 1935 Act was the structure selected for the benefit package. Social insurance programs must strike a balance between the conflicting objectives of "individual equity" and "social adequacy." In some countries (e.g., West Germany) retirement benefits are scaled fairly directly to the worker's preretirement earnings level. The monthly benefit paid to a higher-wage worker exceeds that paid to a lower wage worker by roughly the same proportion that the higher-wage earner's preretirement earnings had exceeded those of the lower-wage earner. This kind of benefit structure is said to stress the individual equity objective in that benefits are roughly proportional to preretirement earnings and hence to the level of the worker's past social insurance contributions.[3] On the other hand, in other countries (e.g. The Netherlands) Social Security pays flat-rate benefits. In these systems each worker receives upon retirement the same monthly benefit (perhaps scaled for years over which contributions had been made) regardless of the level of his or her preretirement earnings. This structure is said to stress the social adequacy goal of assuring at least a minimum level of retirement income.

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[1] Perhaps the most popular of the alternative proposals was the so-called Townsend Plan, which, it was argued, would both help the aged and cure the Depression. Under this plan, all citizens over 60 would be given a cash grant of $200 a month regardless of their financial circumstances. The only condition for receipt of the grant would be that the amount be spent within one month. (At the time, $200 a month was almost twice the amount earned in a month by the average worker.) Proponents of the plan proposed that it be financed by a 2-percent national transaction tax. The plan had considerable political support despite the fact that public finance experts could never figure out how a 2-percent transaction tax would raise nearly enough money to finance the proposed expenditures.

[2] The Act also created the Unemployment Insurance and Aid to Dependent Children programs.

[3] The West German system does have several significant features that reflect social adequacy concerns, however. These include special earnings credits for long-service, low wage workers and benefits for widows and widowers.

Most countries structure their social security programs to strike a balance between these two objectives, and the striking of such a balance has been the policy in the United States from the beginning. Social Security in the United States always contained elements of individual equity in that higher-wage workers would receive at retirement larger monthly benefits than were received by lower-wage workers. It also had elements of social adequacy, however, in that the ratio of the benefit received by a low-wage earner to that earner's preretirement earnings exceeded the ratio of the benefit received by a higher-wage earner to the higher earner's preretirement earnings. In other words Social Security would "replace" a greater fraction of the preretirement earnings of the low earner than of the higher-wage earner. Under the 1935 Act, when the system was fully mature, retirement benefits for an earner with wages at the maximum amount taxable would represent only 34 percent of preretirement earnings; benefits for an average earner would represent 58 percent of the worker's preretirement earnings level; and benefits for a worker whose earnings averaged only half of those of the average earner would replace 73 percent of preretirement earnings.

B. SUBSEQUENT DEVELOPMENT OF PUBLIC INCOME PROGRAMS

The public income security programs created in 1935 have been modified and extended repeatedly in the years since. Some of these changes represented extensions envisioned in 1935, but for one reason or another not enacted then. Others represented modifications to the basic provisions of the original Social Security Act. To a surprising degree, however, many of the basic elements of the public income security programs today are largely the same as they were when the programs were established almost 50 years ago.

Perhaps the most substantial modification to the structure of Social Security occurred in 1939, just four years after the program was created and before its first benefits were paid. There were two major changes. First, the benefits computation procedures were restructured so that benefits payable to workers retiring in the early years of the program—the 1940's and 1950's—were increased, while benefits scheduled for workers reaching retirement age when the program was fully mature—in the 1970's and 1980's—were reduced. Secondly, benefits for single retirees were reduced and monthly benefits were added for the dependents of retired workers and for the widows and children of workers dying before they reached retirement age. The program became Old-Age and Survivors Insurance.

The 1939 reshuffling of the benefit package had virtually no effect on average projected costs over the 40-year period from 1940 through 1980. The extra cost of monthly benefits to dependents of retired workers and survivors of deceased workers was offset by the savings produced by reducing benefits for single workers. The higher costs for benefit payments in the 1940's were offset by lower annual costs for benefit payments in the 1970's and 1980's. However, both changes had the effect of increasing the relative importance of social adequacy concerns at the expense of individual equity concerns in the Social Security benefits structure.

In the original Social Security Act, coverage was limited to wage and salary employees in private sector commercial and industrial enterprises. Federal Government and railroad employees as well as State and local government employees were excluded. The former already had an adequate pension program sponsored by the Federal Government. The latter was excluded on the grounds that the Federal Government could not require participation because (it was then widely felt) the Constitution of the United States did not empower the Federal Government to levy a tax on State governments. Self-employed individuals (including farmers and professionals) and farm and domestic workers also were excluded, at least in part because of a fear that it would be very difficult to administer equitably a payroll tax levied on these workers.

Several amendments in the 1950's substantially reduced the number of American workers not covered by the Old-Age and Survivors Insurance program. Mandatory coverage was extended to most self-employed individuals, to farm and domestic workers, and to members of the Armed Forces, while private nonprofit employers and State and local governments were given the option of electing to be covered by Social Security. Over the years, the Railroad Retirement program has been modified so that today its basic benefits and financing arrangements so closely resemble

Social Security that it operates almost as if railroad workers were covered directly by Social Security. Finally, in 1983 mandatory coverage was extended to all civilian employees of the Federal Government hired after 1983 and to all employees of nonprofit establishments. In addition, those State and local governments which had elected coverage earlier were prohibited from terminating.

The two major expansions in the scope of the Social Security program have been the addition of disability insurance in 1956 and of Medicare in 1965. Both of these additions had been identified by the program's early architects and advocates as desireable future additions to the benefit package, but they proved to be more controversial than the program of cash benefits for the aged. Each was adopted only after extended debate in the Congress and across the country, and each was established with its own identifiable portion of the Social Security payroll tax and its own separate trust fund. Initially, disability benefits were paid only to workers who were over age 50. However, in 1958 benefits were extended to those dependents of disabled workers that would qualify for benefits if they were dependents of retired workers, and in 1960 eligibility was extended to workers under age 50. Initially, Medicare was only available to those 65 and older; in 1972 it was extended to cover most disabled workers as well.

Although the cash benefit package has been modified repeatedly by the Congress in the years since 1939, there have been few changes in its basic structure. Among the more important modifications were:

(1) The addition (in 1956 for women and 1961 for men) of actuarially reduced benefits for workers aged 62 to 65;

(2) Increases (in 1956, 1972, and, with more limited applicability, 1983) in the monthly benefit paid to surviving widows and widowers;

(3) The addition (in 1965) and subsequent liberalization (in 1972, 1977, and 1983) of benefits for divorced women (and, beginning in the late 1970's, men);

(4) The addition (in 1965) and subsequent repeal (in 1981) of benefits for students aged 18 through 21; and

(5) The freezing (in 1977) and subsequent repeal (in 1981) of the minimum benefit.

Average benefit levels have been adjusted repeatedly to keep them more or less in line with changes in prevailing wage and price levels. In general, these adjustments were insufficient to keep up with wage and price changes in the 1940's but exceeded wage and price increases from the mid 1960's through 1972. Increasing awareness of the need to adjust the program for changes in nominal wage and price levels eventually led to automatic indexing. Legislation enacted in 1972 indexed benefits automatically to the consumer price index, and the current procedure for calculating initial benefit amounts and for indexing that calculation was adopted in 1977.

In addition to the means-tested program of Old-Age Assistance, the Social Security Act of 1935 authorized Federal grants to States to pay part of the costs of cash assistance to needy blind people. In 1950, another program was added which provided Federal grants to defray partially the costs of State assistance to the needy who were permanently and totally disabled. In 1974, the structure of these cash assistance programs changed considerably, when the older programs of Federal grants to States were replaced by the Federal Supplemental Security Income Program (SSI). The SSI program guarantees a nationally uniform, Federal-financed minimum income to all needy aged, blind and disabled. Under this program, however, State governments are given the option of providing their residents with higher benefits than are provided under the Federal program. Since many States do supplement the Federal SSI payment, benefit levels continue to vary from State to State.

Despite the increased Federal role in providing means-tested assistance, the importance of this type of aid has declined over the years while the size of the insurance program has grown significantly as it has matured. These trends are illustrated in Table 1, which shows the number of aged persons receiving Social Security and/or public assistance per 1,000 aged persons in the U.S. population. In 1940, 7 out of 1,000 aged persons were receiving Social Security benefits, while 217 out of 1,000 received Old-Age Assistance. By 1980, 914 out of 1,000 aged persons were receiving Social Security, while only 87 were receiving SSI.

TABLE 1.—PERSONS 65 OR OLDER RECEIVING SOCIAL SECURITY AND/OR MEANS-TESTED ASSISTANCE, 1940–80

Year	Aged recipients per 1,000 aged persons			
	OASI	OAA or SSI	OASI and SSI	OASI and/or SSI
1940	7	217	1	223
1950	164	224	22	366
1960	616	141	41	716
1970	855	104	63	896
1980	914	87	61	941

Source: Social Security Bulletin, Annual Statistical Supplement, 1982, Table 167.

III. OLD-AGE, SURVIVORS, AND DISABILITY INSURANCE (OASDI) PROGRAM

A. DESCRIPTION OF THE PROGRAM

The essential elements of the Social Security program are that it:

1. Is contributory, in that it is financed virtually exclusively by worker and employer contributions in the form of payroll taxes.
2. Pays an earnings related benefit, the size of which depends on, but is not directly proportional to, the earnings upon which prior contributions were made.
3. Is designed to replace only a portion of preretirement (or disability) earnings, especially for workers with earnings at or above average.
4. Is designed to encourage supplementation of benefits through private pensions and savings by paying benefits without a test of individual need.

Eligibility.—To be eligible for retirement benefits a worker must have worked a mimimum amount of time in employment that is covered by the program (and, hence, subject to the Social Security payroll tax). Workers reaching retirement age after 1990 must have worked the equivalent of 10 years in covered employment to qualify for benefits. Those reaching retirement age today must have worked at least one-quarter of the time between 1950 and the year they turn 62.[4]

More than 90 percent of the wage and salary workers and self-employed individuals in the United States are in employment covered by Social Security. The vast majority are in jobs for which coverage is mandated by law. Coverage is not mandated, but may be elected, for employees of State and local governments; under the 1983 legislation, once coverage has been elected it can not be terminated. About 70 percent of the employees of State and local governments are covered by Social Security. Prior to 1984, civilian employees of the Federal Government were not covered, but all such persons hired after 1983 are covered.[5]

Computing the Basic Benefit.[6]—Social Security benefits are based on the worker's career average taxable earnings. When a worker files for retirement the worker's taxable earnings for each year since 1950 are adjusted to reflect the increase in economy wide earnings levels occurring since the year the earnings were actually received.[7]

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[4] A worker turning 62 in 1984 must have spent 8¼ years in covered employment to be eligible for retirement benefits. If a worker has sufficient attachment to covered employment to be eligible for—technically, "insured" for—retirement benefits, that worker also has sufficient credits to qualify his (or her) survivors for benefits in the event the worker dies. Those workers who die before they reach retirement age are insured for survivor benefits if they have been in covered employment for at least one-quarter of the years elapsing between the year they turned 21 (or 1950, if they turned 21 before 1950) and the year they died. To be insured for disability benefits, a worker must: (1) be insured for survivor benefits in the manner just outlined and, in addition, (2) have worked at least 5 of the previous 10 years in covered employment. Disabled workers under age 31 have to meet an alternative rule, and no one is ever insured for survivor or disability benefits without at least 1½ years in covered employment.

[5] Technically, persons employed by railroads are covered by their own retirement program instead of Social Security. However, the railroad retirement and Social Security programs are so closely coordinated that for virtually all intents and purposes, railroad workers are covered by Social Security.

[6] The computation described here is the regular procedure applicable to persons turning 62, dying, or becoming disabled after 1979. A different (though comparable) procedure was in general use prior to 1979. There is also an "old-start" method which uses earnings credits back to 1937, but which is now rarely used because it usually produces a lower benefit. Finally, a special transitional guarantee which is similar to the method used previously can be used by people who reach 62 between 1979 and 1983.

A few of the years in which indexed earnings were the lowest are dropped, and the figures that remain are averaged to produce the worker's average indexed monthly earnings or AIME.[8] For workers reaching retirement age after 1990, AIME's will be computed over the highest 35 years of earnings. The use of a career average introduces some recognition of length of service into the calculation: If a worker does not have as many years of earnings as are required by the calculation, one or more years with zero earnings must be used.

The building block upon which all benefit amounts are based is called the primary insurance amount, or PIA. It is the benefit paid to a worker retiring at the normal retirement age, currently age 65. The PIA is calculated by applying a three-bracket "benefit formula" to the AIME. For workers dying, becoming disabled, or reaching 62 in 1984, the primary insurance amount is:

90 percent of the first $267 of AIME, plus
32 percent of the next $1,345 of AIME, plus
15 percent of the remainder,

with the result increased by the amount of any general benefit increases, such as cost-of-living adjustments, after 1984.

Each year, the bracket boundaries in the benefit formula are increased (or, if appropriate, decreased) by the percentage change in average wages in the economy. This produces the benefit formula applicable for workers dying, becoming disabled, or reaching 62 in the subsequent year. The adjustment has the effect of increasing the average initial retirement benefit awarded to successive cohorts at roughly the same rate as average money wage levels are increasing.

Adjustments for Age First Drawn.—Monthly benefits are permanently increased or decreased if first drawn after or before age 65. Benefits are reduced by 6⅔ percent for each full year before age 65 that they are first drawn. A worker's benefit at age 62, the age at which retirement benefits are first payable, thus amounts to about 80 percent of the primary insurance amount. Benefits are increased by 3 percent for each year after age 65 (up to age 70) that payment is delayed. A worker first claiming benefits at age 70 therefore receives a monthly benefit equal to 115 percent of the PIA.

The 1983 legislation scheduled future adjustments in the normal retirement age and the adjustments for early and delayed retirement. An increase in the credit for delaying retirement will be phased in beginning with the cohort turning 62 in 1987. Their benefits will be increased by 3½ percent per year for each year that benefit receipt is delayed after the normal retirement age. The credit is increased by one-half percentage point for every other cohort until it reaches 8 percent per year for those turning 62 after 2004. In addition, the normal retirement age is scheduled to increase by 2 years beginning in the year 2000. It will rise from 65 to 66 in the first decade after the year 2000 and from 66 to 67 in the third decade of the 21st century.[9] Early retirement benefits will still be available at age 62 after the retirement

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[7] Technically, the earnings are indexed to the level prevailing the year the worker turned 60. For workers who die or become disabled before reaching age 62, earnings are indexed to the level two years before the date of death or disability. The two-year lag occurs because the measure used to construct the index first becomes available about ten months after the close of the year to which it applies. Retired workers' earnings are indexed to the level prevailing the year they turn 60 because workers are first eligible for benefits at age 62.

[8] In computing their AIME, workers must use as many years of indexed earnings as there are years elapsing between 1955 and the year the worker turns 62. A worker turning 62 in 1984 averages over the highest 28 years. Workers may use earnings from any year after 1950 in the calculation. If the worker turning 62 in 1984 retires at age 62, there will be 33 annual earnings figures (starting with 1951 and ending with 1983) in his earnings record. In effect, the worker gets to drop the lowest 5 from the calculation. Earnings in the year the worker reaches age 62 and later years may be substituted, without indexing, for lower indexed earnings in earlier years. Thus, if the worker continues to work until age 68 (in 1990), the worker will have 39 annual earnings figures in his earnings record and can drop the lowest 11. Workers who die before reaching age 62 average over the number of years equal to the number elapsing between 1955 and the year of death. The averaging period for older disabled workers is the same as that for workers who die before age 62. The rules for younger disabled workers (those becoming disabled before age 47) are more complicated.

[9] Under current law, the normal retirement age is 65 for workers born in or before 1937; it increases by 2 months for each birth cohort beginning with the 1938 birth cohort and ending with the 1943 birth cohort. It is 66 for those born between 1943 and 1954, but again increases by 2 months for each birth cohort beginning with the 1955 birth cohort and ending with the 1960

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age increases, but they will be further reduced relative to the primary insurance amount. When the normal retirement age is age 67 workers retiring at age 62 will receive 70 percent of their PIA rather than 80 percent.

Dependents' Benefits.—Monthly Social Security benefits are also available for certain spouses and for minor children of workers receiving retirement benefits. In theory, each child under age 18 receives a benefit equal to 50 percent of the PIA; a spouse caring for such a child under age 16 can receive a benefit equal to 50 percent of the PIA, and a spouse age 65 or over when benefits are first claimed also gets 50 percent.[10] In practice, a maximum limits the amount payable on the basis of any single earnings record. The maximum is about 150 percent of the primary insurance amount at lower earnings levels and about 175 percent of the PIA at higher levels.[11] Thus, a retired worker and his wife would receive 150 percent of the worker's PIA, while a worker with a wife and one child would receive the maximum benefit payable based on the worker's earnings, which is less than 200 percent of the worker's PIA.

Disabled workers receive a monthly benefit equal to their PIA regardless of their age. Their dependents are entitled to benefits under the same circumstances and in the same amounts as the dependents of retired workers. However, the limit on benefits for disabled workers' families is somewhat lower than for retired workers with the same PIA.

Aged widows (and widowers) of insured workers are eligible for a benefit equal to the worker's PIA if they first draw the benefit at the normal retirement age.[12] If either they (or their deceased spouses) draw a benefit before the normal retirement age, the widow(er)s benefit is permanently reduced. The benefit can be drawn as early as age 60, but if drawn at age 60, is equal to 71.5 percent of the PIA. Monthly benefits are also payable to the minor children of deceased workers and (if there is a child under age 16 receiving benefits) to a surviving spouse, regardless of age. Each receives 75 percent of the PIA subject to the limits imposed by the family maximum provision.

It is not uncommon for one person to be entitled potentially to more than one benefit at a given time—as, say, a retired worker and as the spouse or widow of a retired worker. Those people are said to be "dually entitled" and are paid an amount equal to the higher benefit for which they qualify.

Earnings Test.—Social Security beneficiaries will have all or some of their benefits withheld if their earnings in a given year exceed a certain "exempt amount." In 1984, the exempt amount is $5,160 for beneficiaries under age 65, and $6,960 for those age 65 and over. Full benefits are paid as long as annual earnings are below these amounts; but if earnings exceed these levels, $1 in benefits is withheld for each $2 by which earnings exceed the exempt amount.[13] The exempt amounts are increased automatically each year by the percentage increase in average wage levels.

Cost-of-Living Adjustments.—Post-entitlement benefit levels are adjusted automatically to reflect increases in the cost of living as measured by a national consumer price index (CPI). The average value of the index in the third calendar quarter of the year is compared to its value at the time the last automatic increase was triggered.[14] If the measure has increased by at least 3 percent, all monthly benefits are increased by the same percentage amount as the CPI index was increased. The increase is effective with the January checks. The size of the cost-of-living increase is constrained not to exceed the increase in average wages occurring in the calendar

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birth cohort. It is age 67 for all workers born after 1960. The normal retirement age for widows born in any given year is equal to the normal retirement age for workers born 2 years previously.

[10] Spouses' benefits can be claimed as early as age 62 even if there are no minor children. However, they are permanently reduced by 25/36 percent for each month by which the spouse is under age 65.

[11] The maximum family benefit actually varies from 150 percent of the PIA at low PIA levels to 188 percent of the PIA at the middle level and drops to 175 percent at relatively high PIA levels. This variation is largely the result of historical accident.

[12] If a worker dies before reaching age 62, the widow(er) is not disabled, and the widow(er) is under 60 when the worker dies, the worker's PIA is adjusted to reflect increases in average wage levels occurring after the worker died.

[13] Beginning in 1990, $1 of benefits will be withheld for every $3 in excess earnings beginning with the year the beneficiary attains the normal retirement age.

[14] But no earlier than the third quarter of 1983.

year preceding the time at which this calculation is being made if the wage increase is less than the CPI increase and the program's financial reserves are very low.[15]

B. STRUCTURE OF BENEFITS

As noted, the Social Security benefit formula is structured to provide higher benefits to the worker with higher average career earnings, but to provide the worker with the lower AIME's a benefit that represents a higher fraction of the worker's preretirement earnings average. The formula thus is weighted to favor those with lower average earnings. The weighting is usually justified on the grounds that higher paid workers are more likely to have (or alternatively should be expected or encouraged to have) substantial income from other sources, such as employer pensions and individual savings and investments, to supplement Social Security benefits.

The practical effect of the structure is illustrated in the table below which compares hypothetical replacement rates at different current earnings levels. The comparison focuses on three workers, one whose earnings were always at the level of full-time work at the minimum wage level allowed by Federal law, one whose earnings have always been equal to the average for all workers under Social Security, and one who has always earned the maximum amount that is taxed and credited for benefit purposes. The table shows the 1983 earnings level for each and the ultimate replacement rate afforded each by the current Social Security law. (The replacement rate shown here is the benefit for a worker retiring at the normal retirement age as a percentage of the earnings in the year before retirement.)[16]

TABLE 2.—SOCIAL SECURITY REPLACEMENT RATES FOR HYPOTHETICAL WORKERS

Worker	1983 earnings level	Ultimate replacement rate (percent)
Minimum	$6,968	55.1
Average	15,201	41.3
Maximum	35,700	27.7

Source: Social Security Administration, Office of the Actuary.

The replacement rates in Table 2 are for hypothetical, full career workers. In the late 1960's the Social Security Administration began a longitudinal survey which followed a cohort of actual workers as they entered retirement and began to receive Social Security and other retirement benefits. The data in Tables 3 and 4, taken from that survey, reflect replacement rates based on actual benefits received by and the actual earnings of this sample cohort of workers. (The cohort retired in the early 1970's; the calculation uses 1976 benefits and preretirement earnings at 1976 levels.)

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[15] "Very low" means trust fund assets are projected to be less than 15 percent of next year's projected annual expenditures at the end of any year from 1984 through 1988, and are projected to be less than 20 percent of projected annual expenditures at the end of any year thereafter. The calculation focuses on total reserves and total expenditures in Old-Age, Survivors and Disability Insurance.

[16] Because of some complexities arising from the introduction of the new computational system described here, people retiring at age 65 in the next several years will actually have somewhat higher replacement rates than those shown here. Also, because age-65 replacement rates will reflect actual cost-of-living adjustments for the 3 prior years, some year-to-year fluctuation in these rates can be anticipated over the long range. This calculation implicitly assumes that the Federal minimum wage grows in the future at the same rate that average wages grow, although nothing in the law guarantees such a result.

TABLE 3.—THE SOCIAL SECURITY REPLACEMENT RATES FOR A SAMPLE OF ACTUAL WORKERS

Replacement rate quartile	Primary insurance amount			Monthly benefit amount		
	Married men	Nonmarried		Married men	Nonmarried	
		Men	Women		Men	Women
First	35	36	43	34	34	40
Median	40	43	48	38	40	46
Third	47	52	57	46	49	54

NOTE: Preretirement earnings are defined as the average of the middle 4 years from the 10 years immediately preceding retirement (the high 3 and low 3 years are dropped). Earnings above the taxable maximum are ignored.

Source: Alan Fox (1982), Table 2. For details of sample selection and size, see the original article.

As shown in Table 3, the primary insurance amount for the median married man in the survey represented 40 percent of his Social Security covered preretirement earnings, and the monthly benefit was 38 percent of preretirement covered earnings. One-fourth of the married men (generally those with the lowest average earnings) had replacement rates of 47 percent or more, and one-fourth (generally those with the highest average earnings) had replacement rates of 35 percent or less. Replacement rates for nonmarried men and nonmarried women were somewhat higher because their preretirement earnings were somewhat lower.

As discussed previously, Social Security replacement rates for average and above average earners have been set at lower levels in part on the assumption that higher earners would have supplemental, private retirement incomes. The major source of private retirement income is employer-provided pensions. The data in Table 4 are from the same longitudinal survey that produced the data in Table 3 and illustrate how Social Security benefits and private pension benefits interact.

TABLE 4.—1976 SOCIAL SECURITY AND SECOND PENSION REPLACEMENT RATES FOR A SAMPLE OF ACTUAL MARRIED COUPLES

Preretirment earnings [2]	Percent receiving second pensions	Replacement rate [1]	
		Social Security only	Total
1st quintile (under $6,891)	9	76	79
2nd quintile ($6,891 to $10,799)	35	55	60
3rd quintile ($10,800 to $13,765)	57	45	57
4th quintile ($13,766 to $18,026)	69	37	50
5th quintile (over $18,027)	76	28	46

[1] Benefits in 1976 prices divided by average earnings.

[2] Combined average preretirement earnings of husband and wife, including estimate of earnings above the Social Security maximum. Average constructed by indexing all earnings to levels prevailing in 1976, dropping lowest 3 and highest 3 years in the 10 years prior to retirement, and averaging the remaining 4 years.

Source: Fox (1982), Table 8. Data based on a sample of 1,859 cases. For further details, see source.

Table 4 focuses only on married couples. In constructing the replacement rates in this table, the couple's combined monthly benefits from both Social Security and private pensions are compared to estimates of the combined total preretirement earnings of husband and wife. As expected, the Social Security replacement rate declines as preretirement earnings levels rise. However, the incidence of private pension receipt rises as preretirement earnings levels rise, and the increasing prevalence of private pensions at higher earnings levels serves, as was intended, to offset partially the reduction in Social Security replacement rates.

C. FINANCING

For the cash benefit programs and the hospital insurance part of Medicare, the vast majority (usually over 95 percent) of the necessary revenues are derived from the Social Security payroll tax. This tax is a flat rate tax levied at equal rates on employers and employees and applied to all earnings up to a specified annual maximum; in 1984, $37,800. The taxable maximum is indexed to rise at the rate average wage levels are rising and is adjusted each time a cost-of-living increase occurs; the maximum sets a ceiling on both the amount of earnings that can be taxed and the amount that can be credited for benefit computation purposes in any given year. At the current level of the taxable maximum, about 90 percent of all earnings derived from employment covered by the program are taxable and about 94 percent of the people who work in covered employment are taxed on their entire annual earnings.

The proceeds of the payroll tax, along with any other revenues used to support the program, are deposited in special Treasury accounts—the trust funds—and all benefit payments and administrative expenses are charged to these accounts. There are separate accounts for Old-Age and Survivors Insurance (OASI), Disability Insurance (DI) and each of the two parts of the Medicare program. Hospital Insurance (HI), which is Part A of Medicare, is financed almost entirely from payroll taxes in much the same way as are the cash benefit programs: Supplementary Medical Insurance (SMI), which is Part B of Medicare, is financed from participant's premiums and the general revenues.

The law specifies both the aggregate payroll tax rate and the manner in which payroll tax revenues are to be divided among the three payroll tax-financed programs. Currently scheduled tax rates for either employees or employers are shown in Table 5. Since employees and employers each pay the rate shown in Table 5, the combined cost in 1985 is two times 7.05 percent, or 14.1 percent of taxable payroll. Also, in 1984 there is a one-time general revenue financed tax credit for employees equal to 0.3 percent of taxable wages. In principle, the employee will be paying 7.0 percent into the Social Security trust funds as shown above. But in practice, the employees' liability is immediately reduced to 6.7 percent of taxable pay because of the one-time tax credit. Employees will have the full 7.05 percent tax deducted in 1985.

In the past, Social Security benefits were exempt from Federal taxes. Beginning in 1984, however, a portion of Social Security cash benefits may be counted as income for purposes of computing Federal personal income tax liabilities. Benefits remain tax free for single taxpayers with incomes of less than $25,000 and married couples filing jointly with incomes of less than $32,000.[17] Taxpayer units with incomes in excess of these limits (as well as all married couples filing separate returns) must include up to one-half of their Social Security benefits as taxable income. Amounts equivalent to the estimated quarterly proceeds from taxing benefits are deposited in the Social Security trust funds. These revenues are projected to amount to just over $2.5 billion in calendar 1984, and should constitute the second largest source of revenue for the cash benefit program in that year.

TABLE 5.—CURRENTLY SCHEDULED SOCIAL SECURITY PAYROLL TAX RATES

[In percent]

Year	OASI	DI	OASDI	HI	OASDHI
1984	5.2	0.5	5.7	1.3	7.0
1985	5.2	.5	5.7	1.35	7.05
1986–87	5.2	.5	5.7	1.45	7.15
1988–89	5.53	.53	6.06	1.45	7.51
1990–99	5.60	.6	6.20	1.45	7.65
2000 and later	5.49	.71	6.20	1.45	7.65

Source: 26 U.S.C. 3101 and 26 U.S.C. 3111.

IV. CURRENT FINANCIAL PROJECTIONS

Social Security is financed on a current cost basis. This means that most of the revenues collected in any given year are used to finance the benefits paid that year. Traditionally, the balances in the trust funds have been viewed as contingency reserves whose primary purpose is to cushion temporary imbalances between income and outgo.

An annual report of the trust funds' Board of Trustees is submitted to the Congress each spring showing detailed projections of costs and revenues for 75 years into the future. The projections are made under three or four different sets of assumptions about key future demographic and economic developments. Additional projections of short-range financial performance are prepared at other times during the year.

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[17] For the purpose of this calculation, income is defined as adjusted gross income plus one-half of the Social Security benefit received plus certain other sources of income that are otherwise exempt from Federal income taxes. The income limits are not indexed.

The data in Table 6 are from the most recent short-range estimates of the status of the Social Security cash benefit program. These projections are based on the economic assumptions used for the 1984 Trustees' Report.

They suggest that the balance between revenues and expenditures will be very close between now and the end of 1987, although income is projected to exceed outgo in each of the years. The financial condition is projected to improve dramatically beginning in 1988, largely as a result of the higher OASDI tax rate which goes into effect that year. Under these projections, the final portion of the loan from HI is paid off during 1987, and the program experiences substantial surpluses into the 1990's.

TABLE 6.—ESTIMATED OPERATIONS OF THE OASDI TRUST FUNDS COMBINED UNDER PRESENT LAW ON THE BASIS OF THE 1984 TRUSTEES REPORT (INTERMEDIATE (B) ASSUMPTIONS), CALENDAR YEARS 1983–93

[Amounts in billions]

Calendar year	Income	Outgo	Interfund transfers [1]	Net change	Funds at end of year [2]	Reserve ratio [3] (in percent)
1983	$171.3	$171.2		$0.1	$24.9	14
1984	184.4	181.5		2.9	27.7	21
1985	203.2	194.1		9.1	36.8	21
1986	221.6	209.3	−$5.5	6.7	43.6	25
1987	241.2	226.2	−6.9	8.1	51.7	27
1988	277.2	243.4		33.8	85.4	29
1989	301.2	260.3		41.0	126.4	41
1990	331.8	277.6		54.3	180.7	54
1991	356.9	295.1		61.8	242.5	69
1992	382.5	313.5		69.0	311.5	85
1993	410.4	332.8		77.6	389.1	101

[1] Transfers to HI Trust Fund to repay earlier loans (Transfers between OASI and DI are netted out).

[2] For 1983–85, includes $12.4 billion outstanding loan from HI. Projections show loan being repaid in 1986–87 time frame.

[3] Assets at beginning of year as percentage of outgo during year. Assets include the advance tax transfer for January.

Source: Social Security Administration, Office of the Actuary, Memorandum on Estimated Operations of the OASI, DI, and HI Trust Funds on the Basis of the 1984 Trustees Report Assumptions, Apr. 5, 1984, Table 4.

Longer-range projections from the 1984 report of the Board of Trustees are summarized in Table 7. These projections express future costs and future income as a percentage of total earnings subject to the payroll tax; the projections employ a pessimistic set of assumptions, an optimistic assumption set, and an intermediate set.

The 75-year projections under the intermediate assumption set are shown at the top and center of Table 7. Costs are projected to average 12.95 percent of taxable payroll, average total revenues are projected to be 12.90 percent of payroll, and the two are essentially balanced.

Not surprisingly, the full picture is not quite as simple as this one 75-year result implies, and some of the complaints are illustrated in the rest of Table 7. For example, the other results at the top of the table show the sensitivity of the cost projections to the demographic and economic assumptions employed. Over the next 75 years, the system could be under-financed by an average 4.1 percent of payroll or could be over-financed by almost 3 percent of payroll if one wishes to employ, alternatively, plausible pessimistic assumptions or plausible optimistic assumptions.

Also, the financial projections differ substantially from one 25-year period to another. Under all three assumption sets, the system runs a substantial surplus over the next 25 years. The OASDI payroll tax now scheduled for 1990 and thereafter is higher than the rate required for current-cost financing, whereas under either the intermediate or pessimistic assumptions, the rate scheduled for the period 2034–2058 is less than current-cost financing would require. The 75-year balance under the intermediate assumption set requires the accumulation of large surpluses in the period 1990 to 2015; these surpluses are then drawn down to cover annual deficits in the years 2034 to 2058. Just before the end of the projection period, the surpluses accumulated earlier will be exhausted and benefit payments can be continued only if taxes are increased or benefits are reduced. Also, under these assumptions, the accumulated OASDI trust fund balance rises to levels unprecedented in the history of the program. By 2015, the balance is projected to be about 25 percent of the gross national product.[18] It remains to be seen whether future Congresses will allow accumulation of surpluses of this magnitude.

One reason such large surpluses might not materialize in the OASDI program is the currently projected financial situation in the payroll tax-financed Hospital Insurance program. HI is now projected to encounter financing difficulties beginning in the late 1980's or early 1990's and under all three assumption sets it faces a substantial deficit over the next 25 years; under the pessimistic assumption set, its 25-year deficit is greater than the surplus projected for OASDI. It is entirely possible that a future Congress will decide to cover a part of the deficit currently projected in the HI program by reallocating a portion of the payroll tax revenues now scheduled to go to the OASDI program after 1990.

TABLE 7.—1984 75-YEAR OASDI INCOME AND EXPENDITURE PROJECTIONS

[Average annual total projected income and expenses as a percent of projected taxable payroll]

	Assumption set		
	Pessimistic	Intermediate (B)	Optimistic
Old-Age, Survivors and Disability Insurance (OASDI)			
Full 75 years (1984–2058):			
Average cost	17.22	12.95	10.01
Average income	13.10	12.90	12.76
Balance	−4.12	−.06	+2.75
1st 25 years (1984–2008):			
Average cost	11.63	10.54	9.36
Average income	12.59	12.56	12.51
Balance	+.97	+2.01	+3.15
2d 25 years (2009–2033):			
Average cost	16.48	13.02	10.15
Average income	13.13	12.97	12.85
Balance	−3.36	−.05	+2.69
3d 25 years (2034–2058):			
Average cost	23.55	15.29	10.52
Average income	13.57	13.16	12.92
Balance	−9.98	−2.14	+2.40
Hospital Insurance (HI)			
25 years (1984–2008):			
Average cost	5.59	4.25	3.32
Average income	2.88	2.88	2.88
Balance	−2.71	−1.37	−.44

Note.—Totals do not necessarily equal the sum of rounded components.

Source: 1984 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Table 32, p. 77 and Summary of the 1984 Annual Reports of the Medicare Board of Trustees, Table 4, p. 9.

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OPTIONS: COORDINATING PENSIONS WITH SOCIAL SECURITY (THE OFFSET INTEGRATION APPROACH FOR DEFINED BENEFIT PENSION PLANS)

(By Manuel F. Castells)

WHAT IS INTEGRATION?

These forums have been set up to discuss what changes should be made to the pensions of new Federal employees now that they are covered under Social Security. This, the subject of my presentation today, is very much at the heart of the matter. I'll be addressing the simplest of the current integration practices—that of offsetting all or part of the Social Security benefit from the pension benefit that another plan provides. The theory of integration is fairly simple. It seeks to coordinate Social Security and other plan benefits so that, in total, they provide for a reasonable level of retirement income. This reasonable level is usually computed as a percentage of pre-retirement income. Thus integration allows for:

(1) The level of retirement income (excluding personal savings) to be accurately planned for by the plan sponsor.

(2) The tilt in the Social Security benefit towards the lower-paid to be compensated for so that equitable benefits are provided at all pay levels.

This presentation will explore the various integration approaches with emphasis on the offset method for defined benefit pension plans. Alternative integration approaches will be compared and contrasted, along with some discussion of other types of plans and the level of plan benefits.

CURRENT INTEGRATION PRACTICE—CORPORATE PLANS

Defined benefit plans, as the name implies, are pension plans in which the benefit at retirement is specified in some sort of formula. It is the responsibility of the plan sponsor to see that sufficient funds are available to pay for the promised retirement benefits.

Virtually all defined benefit pension plans are either directly integrated with Social Security or are implicitly integrated since benefits are lower than they might be in the absence of Social Security.

(1) The following is a brief description of the commonly used integration approaches:

(a) *Offset.*—This method subtracts an amount equal to some percentage of either the actual or, more commonly, the estimated primary Social Security benefit from the gross plan formula benefit. This offset is generally pro-rated for short service employees. This is the most direct method of integration since the Social Security benefit appears explicitly in the formula. This method could produce low or even no benefits for participants at very low pay levels where the offset approaches the gross plan formula benefit.

(b) *Step-up/Excess.*—Under a step-up plan, benefits relate to compensation, with the benefit rate stepping-up for pay over the integration level. The integration level is related to the maximum taxable wage base for Social Security taxes. For instance, the benefit formula for a career employee might be 30 percent of pay up to the maximum taxable wage base for Social Security taxes plus 50 percent of pay in excess of such wage base. An excess plan is a special case of the step-up where the plan provides benefits only on pay over the integration level. These methods integrate in a less direct manner than the offset since the Social Security benefit never appears explicitly in the plan formula. Also, at least in the case of the step-up method, all participants will earn some benefits under the plan.

(c) *Cap.*—The gross plan formula benefit plus the primary Social Security benefit is limited to some percentage of final or final average pay. This approach bears some similarities to the offset. Many plans use the cap as a maximum limit on plan benefits that are already integrated under another method.

(d) *Implicit.*—The level of gross plan formula benefits is lower for all participants than it would be in the absence of a Social Security program. Implicit integration is commonly found in plans that cover participants who earn similar salaries (for example, certain union plans). Integrating by simply lowering the otherwise available benefit level is especially appropriate in that situation since the Social Security benefits will be very similar for all such participants. Currently, based on surveys of large corporate pension plans covering salaried employees, about 60 percent integrate by using an offset, 30 percent use a step-up or excess type of formula, and the remaining 10 percent either use a cap or are not explicitly integrated. (See Corporate Pension Plan Study—A Guide for the 80's by Banker's Life or other similar surveys of pension plans for details). As discussed above, the explicit integration percentages will be lower for plans covering primarily union employees. It is also widely held, though little data is available, that integration is much less prevalent among smaller plans.

(2) Legal requirements on maximum integration levels for qualified plans:

Under current regulations, the maximum allowable offset for a private qualified defined benefit plan is 83⅓ percent of the primary Social Security benefit. The 83⅓ percent maximum limit is derived by taking credit for the "employer's 50 percent share" of the Social Security benefit, adjusted for the value of ancillary Social Security benefits. (Using a similar approach, maximum integration limits are derived for step-up and excess plans.)

However, the 83⅓ percent maximum offset is only applicable to a bare bones pension plan. Adjustments to the offset percentage are required for disability and survivor benefits and subsidized early retirement benefits. Therefore, for most plans, the present rules only allow an offset in the 50–60 percent area. These limits and adjustments as currently used are embodied in Revenue Ruling 71–446, which was issued by the Internal Revenue Service in 1971.

(3) Problems in current integration practice:

Current integration rules are overly complex, particularly in regard to the adjustments that must be made to the basic integration limits. Rather than getting overly involved in the present rules, I have attached a copy of a booklet written by Theresa B. Stuchiner, a Partner at Kwasha Lipton, entitled "How to Integrate a Retirement Plan with Social Security."

Also, even if the theoretical basis underlying the rules is valid, the actual limits and adjustments developed in 1971 were based on the Social Security law then in effect. Since then many significant changes have taken place, making the current rules somewhat outdated and obsolete.

Additionally, explicitly integrated pension plan formulas result in benefits that are more difficult to calculate for the plan administrator and more difficult to understand for the plan participant. Plan participants often feel that integration is a way of taking away benefits that they have earned. Therefore, in order to avoid such misconceptions and confusion as well as to communicate the benefit program clearly, it is important that the integration be as concise and clear as possible.

Finally, there is the problem of low or no plan benefits for short service or low paid participants as well as inequities in replacement rates that can result in over or under pensioning for some plan participants.

FIFTY-PERCENT OFFSET PROPOSAL

A number of proposals designed to simplify the current integration rules have been devised. One of these, the "50-percent offset proposal", simply has a maximum integration limit of 50 percent for offset plans. This limit is based on the "50-percent employer's share" of the Social Security benefit. (Using the same approach analogous limits are derived for step-up and excess plans). The major advantage of this proposal is that very few, if any, adjustments to the integration limit are necessary.

(1) Compatibility with current corporate practice:

The 50-percent offset proposal ties in nicely with current integration practice since offsets for most plans are in the 50–60 percent range. Also, the 50-percent offset limit does not need to be adjusted as Social Security benefits change in the future. The limit is tied only to the employer's share of the Social Security benefit.

(2) Few adjustments to the 50-percent offset are needed:

The 50-percent offset proposal requires little adjustment for ancillary benefits. Disability benefits are handled by simply offsetting 50 percent of the disability Social Security benefits. Also, no adjustment is needed for most death benefits. A problem arises, however, if early retirement benefits are subsidized or payable prior to age 62 (the earliest age for commencement of Social Security benefits). In this case a number of simple alternatives are available under the 50-percent offset proposal. These adjustments effectively reduce the amount of the offset to take account of the richer plan benefits. While this approach ties in with current integration rules for qualified plans, it may be modified or eliminated for the purposes of the CSRS plan.

A problem with the 50-percent offset (as with any other integration proposal that complies with current law) is that the full tilt of Social Security benefits towards the lower paid cannot be compensated for. The only alternative which accomplishes that is a full offset of the Social Security benefit.

(3) A 100-percent offset may be more appropriate in the absence of legislative requirements since it offsets the full Social Security tilt:

For the CSRS plan, it may be advantageous to approach Social Security integration from a different point of view. Instead of looking at the employer's share of the Social Security benefit as the appropriate limit, let's construct an integration method which attempts to provide equitable benefits at all pay levels considering Social Security and the plan benefit as a unit. This approach leads to a 100-percent offset of the Social Security benefit as being the appropriate integration method. This method is not allowable under current integration rules for private qualified plans, but in the absence of any legal restrictions for a government plan, it may be preferable to a lesser offset percentage. By offsetting the full Social Security tilt towards the lower paid, fair benefits at all pay levels will be provided. This method is also easy to communicate to plan participants since the integration is explicit and simple, and is being utilized in order to provide equitable benefits for all plan participants.

COMPARING OTHER INTEGRATION METHODS TO OFFSET

(1) The step-up/excess approach has several disadvantages relative to the offset:

(a) Having two different rates of benefit accrual results in a plan formula that is cumbersome and difficult to understand.

(b) The integration limit for determining which part of a participant's pay receives the higher accrual rate should be updated each year based on the new Social Security wage base. This results in a basic plan formula that changes from one year to the next. Alternatively, if the integration limit is not adjusted annually, the plan gradually becomes less and less integrated. This occurs because the pay levels of participants are generally rising while the integration limit remains level.

(c) The indirect nature of Social Security integration under this method obscures the impact of the Social Security benefit on the plan benefit. In fact, the Social Security benefit is not explicitly referred to in the formula.

One advantage of the step-up/excess approach is that the benefit is easier to calculate. The Social Security integration limit is constant for all plan participants each year as compared to the offset where the Social Security benefit varies for each individual.

Also, there is no perception of earned benefits being "taken away" as can occur with the offset since nothing is being subtracted out.

(2) The cap approach is essentially the same as the offset for final average pay plans. For other types of plans the cap, if it is to be effective for most plan participants, would make the plan appear to be a final average pay plan. But a well designed integration method should not change the basic type of plan formula. On the other hand, if the cap is not effective for many plan participants, then the plan is not really integrated.

(3) Either implicitly integrating or not integrating has the advantage of simplicity. Also, (as was mentioned above for step-up plans) nothing is being "taken away" from the plan formula. The obvious disadvantage is the fact that the Social Security tilt towards the lower paid is not being taken into account. Therefore, these types of plans, together with Social Security, will provide benefits that are relatively higher for lower paid participants.

The exception to this, as was discussed earlier, is a plan in which the participants are all earning about the same pay. In this situation, implicit integration will be the preferred methods.

FORMAL 100-PERCENT OFFSET PROPOSAL

In light of the foregoing discussion, let's formulate a specific integration approach so that we may examine the problems that can arise in more detail. Our method will be a 100-percent offset of the Social Security benefit, with no adjustments for ancillary benefits. Employee contributions will not be required on pay below the current Social Security wage limit. The offset will be based on the appropriate Social Security benefit for that type of retirement. For example, disability retirements will have the disability Social Security benefit offset. For early retirements before age 62, no offset will be applied until age 62. The offset will be pro-rated for employees with less than full career service (i.e., 30 years).

If any adjustments are to be made for early retirements, all retirements prior to the Social Security unreduced benefit commencement age should be considered as such. This is an important point to clarify in light of the recent amendments to the Social Security laws. Under the current law, the age for commencement of unreduced Social Security benefits will rise gradually from the current age of 65 to age 67.

The Social Security benefit itself will generally be estimated on the basis of tables prepared for that purpose. Alternatively, the benefit may be the actual benefit calculated by the Social Security Administration. The latter approach is more accurate, but also more costly from an administrative point of view. Under current Social Security law, the benefit is quite complicated to calculate.

PROBLEMS WITH 100-PERCENT PROPOSAL

(1) Issue of minimum benefits:

As was discussed previously, the topic of minimum benefits needs to be addressed in connection with Social Security integration. Since employee contributions will be required under the CSRS plan, it may be advantageous to have a plan where all participants get some benefits at retirement. Accordingly, a minimum benefit (perhaps in the form of some flat dollar amount per month for each year of service) should probably be a part of the plan design. It is important to note that these minimum benefits are not really a part of the integration method itself. They are needed, however, in order to ensure some level of plan benefits for all participants at retirement.

(2) Ease of understanding for employees and administrators:

The beauty of the 100-percent offset approach is its simplicity. Although the estimation of the Social Security benefit and the resulting CSRS plan benefit under this approach are not simple to calculate and understand, the benefits provided by the two sources taken together should be well defined (by the CSRS gross plan formula) and easy to communicate. Plan participants will be able to plan financially for retirement without having to know what benefits Social Security will provide. Further, they will not have to worry about potential decreases in Social Security benefits in the future as long as the CSRS plan is there.

(3) Possible alternatives for problem situations (short service, relatively low-paid, etc.):

In spite of the proration of the offset described above, there are still some problems for short service participants. For many, the prorata portion of the Social Security benefit will not be a fair indicator of the amount of the benefit attributable to service with the government.

In particular, for employees with erratic pay histories and gaps in their work record, the estimated Social Security benefit used in the benefit calculation will overstate their actual Social Security benefit and will therefore understate their pension plan benefit. This problem may be solved by using the actual Social Security benefit, although there are a number of practical problems associated with this approach. The most effective approach to this problem as well as the problem, of low or no benefits for lower paid employees, might be to install minimum benefits.

DEFINED CONTRIBUTION PLANS

A defined contribution plan (e.g. savings plan) does not specify a benefit at retirement. The benefit is simply the equal to the amount of money in the participant's account. No benefit level is guaranteed. Therefore, a defined contribution plan is always fully funded. Currently, many corporations are making use of defined contribution plans in their retirement programs. Most of these plans are not integrated with Social Security—that is, the contribution rates are the same at all pay levels. Due to the less stable and unpredictable nature of the defined contribution plan benefit, this type of plan is generally used to supplement a defined benefit pension plan. The defined benefit plan is generally integrated and forms the major part of the retirement income program. We anticipate that, if the CSRS retirement program incorporates a defined contribution plan, it will be used in a similar manner and therefore integration will probably not be an issue.

LEVEL OF PLAN BENEFITS

Finally, a few words should be said about the level of benefits to be provided by the combination of the CSRS plan and the Social Security benefit.

Generally, in the corporate world, a post-retirement income objective is defined. The sources usually considered are (1) pension benefits, (2) Social Security, and (3) personal savings. A common objective is to provide the same level of pre-retirement income to the full career participant after retirement at or after age 65 on a post-tax basis. This approach is probably advisable for the CSRS plan as well. Integrating the CSRS benefit fully with Social Security greatly simplifies the analysis of retirement income objectives and total benefits will be unaffected by future changes in the level of Social Security benefits. Of course, if Social Security benefits were to decrease in the future, the slack would be made up by the CSRS pension plan and the cost of the plan would rise accordingly. Therefore, it is important to follow up the initial retirement income objective at reasonable intervals throughout the life of the plan so that the level of plan benefits may be re-evaluated in light of changing circumstances.

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SPECIAL STUDY

How To Integrate A Retirement Plan With Social Security

1982 Edition

By Theresa B. Stuchiner
Partner, Kwasha Lipton

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[¶1]

GLOSSARY

Career average pay plan	A plan which bases benefits on an employee's actual compensation earned during each year of service or participation.
Covered compensation	For each employee, the average of the maximum amount considered wages for Social Security tax purposes in each of the calendar years during the period beginning with the later of the year in which the employee reached age 30 or 1959 and ending with the calendar year in which the employee reaches age 64.
Excess plan	A plan under which an employee's benefits are based only on his compensation in excess of the integration level. (The term also refers to the excess part of a step-rate plan.)
Final average pay plan	A plan which bases benefits on the employee's compensation averaged over a short period of consecutive years, generally final years, such as the last five years.
Flat-benefit plan	A plan providing a benefit which is a flat percentage of compensation regardless of years of service in excess of the minimum service requirement.
Integration level	The compensation level above which, under a plan's benefit formula, benefits or contributions are determined.
Offset plan	A plan under which the employee's total benefit is computed and then reduced by a percentage of the employee's Social Security benefit.
Step-rate plan	A plan which provides benefits or contributions based on all compensation, but a higher rate of benefit or contribution applies to compensation above the integration level than to compensation below the level.
Taxable wage base	For any year, the maximum amount of earnings considered as "wages" for such year for purposes of Social Security taxes.
Unit-benefit plan	A plan providing a benefit which is a percentage of compensation for each year of service.

WHAT'S CORRELATION WITH SOCIAL SECURITY ALL ABOUT?

[¶2] To qualify for tax-favored treatment, a pension or profit-sharing plan must not discriminate in favor of employees who are highly paid or who are officers or stockholders. This non-discrimination requirement is twofold. The employer must not discriminate in selecting employees to cover in the plan.[1] Nor may he discriminate in determining the benefits or employer contributions under the plan.[2]

The coverage requirement can be met in one of two ways. One is to include at least 70% of all employees (or if 70% or more are eligible to participate, at least 80% of those eligible must be included). The other way is to cover a certain class or group of employees—for example, all salaried employees. But then the Treasury, acting through a local revenue agent, must find that covering just that group doesn't result in favoring the higher-paid. (In determining whether the non-discrimination requirements are met, employees covered by a collective bargaining agreement are not taken into account if retirement benefits were the subject of good faith bargaining.)

In a pension plan, benefits must not discriminate in favor of upper echelon employees. Simply stated, if an employer is going to give a $40,000-a-year man a pension of 50% of his pre-retirement salary, then he must also give the employee earning $15,000 a year a pension of 50% of his pre-retirement earnings. Note that even though the higher-paid employee will receive a higher dollar pension, there is no discrimination because the percentage of pay is the same.

In a profit-sharing plan, or a money-purchase pension plan, the rate of employer contributions must not favor top level employees.

But—and this is where correlation with Social Security comes into play—in determining whether an employer's plan meets the non-discrimination test, the Treasury takes into account the benefits provided by the employer under Social Security.[3] If the combined package of employer-financed Social Security benefits and private plan benefits doesn't favor higher-paid employees over lower-paid employees, the plan will be approved as non-discriminatory. Taken together, the employer's plan and Social Security must result in an "integrated and correlated retirement system" which satisfies the non-discrimination requirement.[4]

In effect, the Social Security system and the employer's private plan are considered part of one over-all program, the employer's plan picking up where Social Security leaves off. So, for example, an employer can exclude lower-paid employees from coverage—as long as the plan benefits for covered employees are comparable in value to the total Social Security benefits paid for by the employer on behalf of the lower-paid employees. Or the employer can provide benefits that are a greater percentage of pay for high-paid employees than for low-paid employees—but only if the relative difference in the benefits is approximately offset by the total employer-financed Social Security benefits.

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* All references are to P-H Pension and Profit Sharing
(1) IRC § 401(a)(3) and § 410(b).
(2) IRC § 401(a)(4).
(3) IRC § 401(a)(5).
(4) Reg. § 1.401-3(e)(1), ¶63,071*.

IN GENERAL

[¶3] Of course, a Treasury-approved plan doesn't have to be correlated with Social Security. A plan which provides a flat monthly pension—say, $10 a month per year of service, or a uniform rate of benefit or employer contribution based on all pay—doesn't directly involve integration with Social Security. Many companies, however, want their private plan benefits directly integrated with Social Security, particularly where the company has one plan covering all employees. The reasons: to fill the Social Security gap and to provide a financial hedge against future Social Security increases.

Social Security gap: Social Security leaves a big gap in the retirement security needs of higher-paid employees. The Social Security Administration estimates that a married male employee whose earnings have always been around the maximum wages covered by Social Security can expect to receive old age benefits (including his wife's benefit) of about 42% of his earnings just before retirement. But the married low-wage earner (someone earning $6,400 in 1981) can expect about 80% of his pre-retirement earnings and the average married wage earner (someone earning about $12,600 in 1981) can expect about 63%. The company's plan can fill in the gap for the higher-paid employees by providing benefits based on pay over the level covered by Social Security or by providing a smaller benefit on pay covered by Social Security and a higher benefit on pay over that level.

Financial hedge: When Social Security started, benefits were small and the tax rate for Social Security benefits low. Today Social Security taxes are taking an ever-increasing bite out of both the employee's paycheck and the employer's payroll dollar. If an employee earns as much as $32,400 in 1982, he and his employer will each pay $2,171 in Social Security taxes. Under the present Social Security law, the tax bill will automatically go even higher in the years ahead, without any further push from Congress, and benefits will keep pace with increases in national average wages and the cost of living. With an integrated retirement plan, the private plan benefits—and the employer's cost—can go down when Social Security benefits and taxes go up.

➠OBSERVATION→ Certain rights in accrued benefits must be nonforfeitable to meet the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Nonforfeitable rights that may be reduced to take into account benefits provided under Social Security are not considered to be forfeitable.[5] But if a non-integrated plan is amended to integrate plan benefits with Social Security, or an integrated plan is amended to increase the

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(5) Reg. § 1.411(a)-4(a), ¶85,176*.

extent of integration, the plan benefit accrued by employees to the date of amendment must, except in very limited circumstances of substantial business hardship, be preserved—that is, the plan benefit ultimately payable to the employee cannot be less than the benefit the employee had earned up to the date of amendment.[6]

The Treasury has developed detailed rules for determining whether a particular private plan, when combined with Social Security, provides an integrated and correlated retirement program that doesn't discriminate in favor of the higher-paid. Before looking at these rules in detail, let's examine briefly the different types of integrated plans.

TYPES OF INTEGRATED PLANS

[¶4] Pension plans (other than money-purchase plans), as we have noted, are integrated with Social Security on the basis of a comparison of the private plan benefits with Social Security benefits. Basically, there are three types of defined benefit integrated pension plans: excess, step-rate, and offset.

(1) *Excess plan:* Under an excess plan, an employee's benefit is based on the employee's pay in excess of a certain amount—the integration level or "breakpoint" as it is sometimes called. An example is a pension plan providing an annual retirement benefit equal to 30% of that part of the employee's pay in excess of $10,800.

(2) *Step-rate plan:* Under a step-rate plan, benefits are provided on all pay, but a higher rate of benefit applies to pay above the integration level than to pay below the level. A step-rate plan is treated for integration purposes as if it were two plans—one providing the lower rate on all pay, both below and above the integration level; the other providing the balance of the higher rate on pay over the integration level. The first plan is not integrated with Social Security since it provides the same rate of benefit on all pay; the second plan is treated as an excess plan. For example, a pension plan calls for a benefit of 20% of the employee's average pay up to $10,800 and 57½% of such pay over $10,800. The 20% part of the plan does not involve integration. The plan is tested for proper integration with Social Security as if it were a plan providing a benefit of 37½% (57½%—20%) of pay in excess of $10,800.

Flat or Unit Benefit: An excess plan can express the benefit as a flat percentage of pay. For example, each employee with at least 15 years of service at retirement gets a pension equal to 37½% of his pay above the integration level. (Here the pension for the $15,000-a-year employee with 30 years of service is the same as the pension for the $15,000-a-year employee with 15 years of service.) Or the plan can express the benefit as a small percentage of pay for each year of credited service (unit-benefit). For example, an employee earns a benefit credit for each year of service equal to 1¼% of his pay over 10,800; his retirement benefit is the sum of all his benefit credits. (Here the employee with 30 years of service gets a pension of 37½% of pay

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(6) IRC § 411(d)(6).

over 10,800; the employee with 15 years service gets a pension of 18¾% of pay over 10,800.)

(3) *Offset plan:* Under an offset plan, no employee and no part of pay is excluded because of a minimum compensation level. The benefit rate and all other provisions of the plan are the same for all covered employees. But the plan benefit is reduced or "offset" by a percentage of the employee's Social Security benefit. For example: a plan calls for a pension of 50% of an employee's average monthly pay minus one-half of his Social Security old age pension.

Defined contribution plans—profit-sharing and money-purchase pension plans: Under a money-purchase pension plan, the employer contributes a flat sum or a flat percentage of pay each year. The employer's contributions (and any by the employee), together with the increments thereon, are accumulated, and when the employee reaches retirement, the amount standing to his credit at that time is used to provide him with retirement benefits. A profit-sharing plan is similar to a money-purchase plan except that the employer's contributions are geared to profits.

Integrated profit-sharing and money-purchase plans are excess or step-rate plans—that is, employer contributions are provided only with respect to pay above the integration level, or a small rate of employer contribution applies to pay up to the integration level and a higher rate above.

Plans covering "owner-employees": Defined benefit pension plans that cover "owner-employees" (sole proprietors or more than 10% partners) may *not* be integrated with Social Security.[7] Defined contribution plans that cover owner-employees may integrate with Social Security if not more than one-third of deductible plan contributions are on behalf of owner-employees. Under the integration rules for owner-employee plans, the Social Security taxes paid by the owner-employees on their own behalf and the employer's Social Security tax for common law employees may be treated as contributions under the plan.[8]

MEASURING THE VALUE OF THE EMPLOYER-FINANCED SOCIAL SECURITY PACKAGE

[¶5] We've said before that to justify excluding lower-paid employees from coverage under the plan, the employer must be providing them with Social Security benefits which are equivalent in value to the benefits he's providing for higher-paid employees covered by the plan. To justify giving greater benefits to higher-paid employees than to lower-paid employees, the employer must be providing low-paid employees with the difference in benefits through the Social Security system.

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(7) IRC § 401(j)(4).
(8) IRC § 401(d)(6).

How is the value of the employer-provided Social Security benefit package measured? Here's where the Treasury integration Regulations and rulings apply.

The value of the employer-provided Social Security benefit package was last measured by the Treasury in integration Regulations issued in 1971. Since that time there have been substantial changes in the Social Security law. Social Security amendments in 1972 introduced the concept of automatically increasing Social Security benefits with the cost of living and automatically increasing the Social Security taxable wage base (the contribution base), which is also the compensation base for determining Social Security benefits (the benefit base), by increases in national average wages. The 1977 Social Security amendments provided a specific formula for computing benefits for future retirees and beneficiaries, including a procedure for indexing a worker's past wages to reflect the increase in national average wages which take place between the year the wages were earned and the time the worker first becomes eligible for Social Security benefits. The 1977 amendments also specified the contribution and benefit base for the years 1979 through 1981 ($22,900 for 1979, $25,900 for 1980 and $29,700 for 1981) with the base now rising automatically with movements in national average wages.

The 1971 Treasury Regulations,[9] which still apply, developed the basic unit of measure this way:

Step 1: Value of Old Age Benefit

The rate at which the maximum old age Social Security benefit is provided under the Social Security law in effect in 1971 is considered to be the average of (i) the rate (46.3%) at which the maximum benefit payable in 1971 was provided to an employee retiring at age 65 in 1971 (which was the then top old age benefit of $213.10 divided by $460, the then maximum recognized pay) and (ii) the rate (39.4%) at which the maximum old age benefit would have ultimately been payable, *i.e,* in 2010 to a male then retiring at age 65 (the scheduled $295.40 top old age benefit divided by the maximum recognized monthly pay of $750). The average of these two rates is 43%.

Step 2: Value of the Total Package

When a married man becomes entitled to an old age pension, his wife also gets a wife's benefit equal to one-half of his old age pension if she's either age 65 or taking care of a dependent child. A benefit of less than one-half is payable if she starts receiving payment between ages 62 and 65. A female worker's husband may also be eligible for a husband's benefit. There's also a benefit for a retiree's dependent unmarried child.

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(9) Reg. § 1.401-3(e)(2), ¶63,072*.

In addition to benefits for spouses and children paid while the retiree is alive, Social Security provides monthly benefits to survivors of a deceased worker, such as a widow's or widower's benefit, a benefit for an unmarried dependent child, and a benefit for a dependent parent. Social Security also provides benefits for a disabled worker and his dependents.

Treasury Regulations say that in 1971 these additional and survivor benefits were equal in value to 62% of the worker's old age benefit. Thus, the total Social Security benefit package, including disability benefits, for the average employee in the work force in 1971 (always earning about the maximum Social Security covered wages) was considered to be 162% of his old age pension, or 70% of the average monthly earnings on which it is based (162% × the 43% rate of benefit payable to the average such employee in the work force).

Step 3: Portion Attributable to the Employer

Since Social Security benefits are funded through equal contributions by the employer and the employee, the Treasury concludes that 50% of the total value of the Social Security benefit package is attributable to the employer's contributions.

The result: On the basis of the assumptions in Steps 1, 2 and 3 above, we can say that the maximum old age, disability and survivor benefits under the 1971 Social Security law attributable to the employer's contributions for the average employee then in the work force (always earning about the maximum Social Security covered wage) is equal in value to an employer-financed lifetime pension for the employee beginning at age 65 equal to 35% of the average monthly earnings on which it is computed—50% × 70% (the percentage arrived at in Step 2).

But anticipating that changes in Social Security in the future might increase the rate of benefit to covered pay, or the value of the additional disability and survivor benefits relative to the old age pension, the Treasury Regulations permit the employer to consider a 37½% pension as the measure of the employer-financed Social Security benefit package.

Thus, an employer's plan won't be discriminatory if it provides a flat benefit at retirement (and no additional or survivor benefits or integrated disability benefits) equal to 37½% of pay in excess of the maximum pay recognized for Social Security purposes ("covered pay") because the employer is providing total benefits equivalent to 37½% of covered earnings through the Social Security system.

The 37½% basic rate of comparison applies only to a flat-benefit excess pension plan (*e.g.*, 37½% of pay in excess of $10,800). The 37½% basic rate must be converted to appropriate equivalent rates for other types of integrated plans. And these basic rates may, in turn, have to be adjusted if the plan provides additional features not reflected in deriving the basic rate.

A 1971 comprehensive Revenue Ruling[10] implements the general basis for integration contained in the Treasury Regulations. The ruling gives the guidelines for integrating all types of plans, with varying features.

Now that we've seen how the basic unit of comparison was arrived at, let's see how the guidelines apply to different types of integrated plans.

FLAT-BENEFIT EXCESS PLAN

[¶6] Let's say the employer has decided that he wants to supplement Social Security by providing a benefit which is a flat percentage of pay above a certain compensation level. What integration level or breakpoint can he use? He can set the integration level at "covered compensation"—a different amount for each employee depending on his age, in line with the method of determining Social Security benefits in 1971—or he can set it at a uniform amount for all employees, for example, $10,800.

"Covered compensation": The concept of "covered compensation" in the 1971 Revenue Ruling was this: the amount of compensation on which an employee's Social Security benefit at age 65 would be based if he had always earned wages at least equal to the maximum Social Security taxable wage base. Under the 1971 Social Security law that would have been the average of the maximum Social Security wage bases in effect from 1956 (or age 27, if later) up to the year the employee reaches age 65. The tables of "covered compensation" in the 1971 rulings are based on the 1971 law.

The Treasury issued new tables of "covered compensation" in 1978 and again in 1982 which reflect changes made in the Social Security law since 1971.[11] The amounts shown in the new tables are based on calculation procedures consistent with those used to produce the 1971 tables but reflecting the Social Security law change that shortened the averaging period. Under the current calculation procedure, "covered compensation" for an individual is the average of the maximum Social Security taxable wage bases for each of the years in the period beginning with 1959 (or the year in which the individual reached age 30, if later) and ending with the year the individual reaches age 64. But in making the calculation, the increases in the Social Security taxable wage bases scheduled for years after the employee separates from service are not taken into account. So the tables of "covered compensation" issued by the Treasury in 1982 are for employees who separate from service in 1982 and the tables assume that the Social Security taxable wage base for years after 1982 will remain at $32,400.

The Treasury table below gives the exact amounts of "covered compensation" for employees who separate from service in 1982 based on the calendar year of the employee's 65th birthday.

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(10) Rev. Rul. 71-446, ¶65,797*.

(11) Rev. Rul. 78-92, ¶95,074* and Notice 82-2, ¶107,412.

Covered Compensation 1982

Calendar year of 65th birthday	Amount
1982	$11,004
1983	$11,892
1984	$12,708
1985	$13,464
1986	$14,172
1987	$14,820
1988	$15,420
1989	$15,996
1990	$16,524
1991	$17,016
1992	$17,484
1993	$17,916
1994	$18,336
1995	$19,128
1996	$19,908
1997	$20,700
1998	$21,492
1999	$22,272
2000	$23,064
2001	$23,856
2002	$24,588
2003	$25,332
2004	$26,028
2005	$26,736
2006	$27,432
2007	$28,140
2008	$28,812
2009	$29,424
2010	$29,976
2011	$30,492
2012	$30,984
2013	$31,440
2014	$31,860
2015	$32,136
2016	$32,316
2017 and later	$32,400

Instead of a table based on exact ages, the employer can use a table of "covered compensation" based on age brackets:

Covered Compensation 1982

Calendar year of 65th birthday	Amount
1982	$10,800
1983	$12,000
1984	$12,600
1985	$13,200
1986	$14,400
1987	$15,000
1988	$15,600
1989	$16,200
1990-1991	$16,800
1992	$17,400
1993	$18,000
1994	$18,600
1995	$19,200
1996	$19,800
1997	$21,000
1998	$21,600
1999	$22,200
2000	$22,800
2001	$24,000
2002	$24,600
2003	$25,200
2004	$25,800
2005	$27,000
2006	$27,600
2007	$28,200
2008	$28,800
2009	$29,400
2010	$30,000
2011	$30,600
2012-2013	$31,200
2014	$31,800
2015 and later	$32,400

Can the employer anticipate future Social Security changes in setting the plan's integration level? Yes, under present rules, by using an open-ended definition of "covered compensation," such as:

For each employee the average of the maximum Social Security taxable wage bases for each of the calendar years from the later of the year in which the employee reached age 30 or 1959 and ending with the calendar year in which the employee reaches age 64, assuming no change in the maximum Social Security taxable wage base after the employee's separation from service.[12]

Uniform dollar amount: The employer can select as the plan's integration level a uniform dollar amount up to the lowest "covered compensation" of any individual who is or may become a participant in the plan.[13] The employer can also choose as the integration level a uniform dollar amount which is higher than the covered compensation of any present or potential participant, but then he must make an appropriate reduction in the maximum integration percentage.

> **Example:** Let's say a company put in a plan on January 7, 1982 covering all employees hired before age 60. None of the employees at that time was over age 45. Since it was possible that an employee reaching age 65 in 1983 (age 60 in 1982) could be hired and covered by the plan, the minimum covered compensation from the 1982 age bracket table (page 13) for any present or potential participant was $14,400. (The employer could have used as the minimum covered compensation the exact amount from the other table (page 13), $14,172.) If the plan's integration level was $14,400 or lower, the employer could use any percentage rate up to the maximum integration rate hereafter mentioned. If the level was higher than $14,400, the rate would have to be reduced.

Maximum integration rate: Under a flat-benefit excess plan with an integration level of "covered compensation" or lower, the normal annual retirement benefit for an employee with at least 15 years of service can't be greater than 37½% of his average annual compensation. The employee's compensation must be averaged over a period of at least 5 consecutive years (or period of service if less than 5 years) under a uniform rule that applies to all employees. In the case of an employee with less than 15 years of service, the pension can't exceed 2½% of average annual compensation in excess of the integration level for each year of service (*e.g.*, for a person with 10 years' service, the maximum rate is 25%). Compensation can be averaged over a period of 3 or 4 consecutive years, but then the maximum rate is reduced to 33¾% or 2¼% if averaged over 3 years, and to 35-5/8% or 2-3/8% if averaged over 4 years.[14]

When the integration level is higher than the "covered compensation" of any present or potential participant, the 37½% and 2½% rates must be reduced by multiplying them by this fraction:

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(12) IRC § 401(a)(15), which provides, in part, that increases in the taxable wage base after the year in which the employee separates from service may not be taken into account.

(13) An excess plan (flat or unit benefit, money-purchase pension or profit-sharing) with two integration levels will be considered properly integrated if the benefit rate at each level does not exceed the maximum permissible rate for each such level. But there is also a way of getting a small "credit" for providing a benefit (or contributions) on the band of earnings between the lower and higher integration levels so as to provide a higher benefit (or contributions) on pay over the higher level. See Section 19 of Rev. Rul. 71-446, ¶65,797*.

(14) Rev. Rul. 72-276, ¶65,864*.

$$\frac{\text{“Covered compensation” of oldest present or potential participant}}{\text{Plan's integration level}}$$

Example: Under ABC Company's pension plan, an employee retiring at age 65 after completing at least 15 years of service will receive a pension equal to 20% of his average salary during the last 5 years of service up to his "covered compensation" plus 57½% of such average salary in excess of his "covered compensation." The plan uses the 1982 age bracket table to define "covered compensation." The plan is properly integrated because the difference in plan rates—37½%—doesn't exceed the maximum integration rate.

Let's say that both John Smith and Richard Jones will have a final average salary of $30,000, but that John will be age 65 in 1987 and Richard in 1997. When John retires, his annual pension will be $11,625 [(20% × $15,000) + (57½% × $15,000)]. When Richard retires, his annual pension will be $9,375 [(20% × $21,000) + (57½% × $9,000)]. Each employee receives a different pension depending on his age.

➠"STANDARD" PLAN→ At the rates discussed above, a plan can provide only a pension, beginning at age 65, payable for the life of the employee. If the plan provides additional benefits (*e.g.*, death or disability benefits) or full benefits before age 65, or if employees contribute, the basic rate must be appropriately adjusted. These adjustments are explained beginning at page 17. For convenience, we'll call a plan without any additional features, a "standard" plan.

UNIT-BENEFIT EXCESS PLAN

[¶7] If the employer decides on a unit-benefit excess plan (see page 8) he has considerable flexibility in the selection of the plan's integration level. The integration level can be any of three alternatives (examples are on page 16).

Alternative 1: Each employee's "covered compensation" or any uniform dollar amount which isn't greater than the "covered compensation" of any present or potential participant. (In either case, the same integration level applies in determining the benefit credit for all the employee's years of service.)

Alternative 2: For any year of an employee's service, the Social Security taxable wage base in effect for that year (except that $4,800 may be used for years before 1959), or a lesser dollar amount.

Alternative 3: For all years of service before a specified date (no later than the end of the year in which the plan is established or amended), the "covered compensation" of an employee reaching age 65 in that year (or a lesser dollar amount), and for each subsequent year of service, the Social Security taxable wage base, or a lesser dollar amount.

Permissible variation: A stated dollar amount that's higher than any of the maximum allowable integration levels described above may be used, but with a proportionately reduced benefit rate.

Maximum benefit rate: A unit-benefit plan may have a formula which credits the employee for pension purposes with a unit equal to a percentage of his current pay during each year of service (often referred to as a career average pay plan). Or the plan may have a formula which credits the employee with a percentage of his compensation averaged over a period of years, such as his average pay in the final 5 or 10 years of employment or the best 5 consecutive years out of the last 10 years (usually referred to as a final average pay plan).

When the benefit is based on actual compensation for each year of service (career average pay), the maximum rate at which the normal retirement benefit can be provided on pay over the integration level is 1.4%. Where the benefit is based on average pay in excess of the integration level, the maximum integration rate is 1%.[15] If the integration level is higher than the maximum allowable integration level, the 1.4% or 1% rate is reduced by multiplying the rate by this fraction:

$$\frac{\text{maximum allowable integration level}}{\text{plan's actual integration level}}$$

⋙**ALTERNATIVE→** Instead of meeting the above rules, a unit-benefit plan may be properly integrated if it meets the tests for a flat-benefit plan. This can be done by limiting the number of years of service which can be counted for benefit purposes—either by an age requirement for plan membership or by a maximum limit on credited service. For example, a unit-benefit plan that provides a benefit of 1¼% of *average* pay in excess of "covered compensation" will be properly integrated if there is a 30-year maximum limit on credited service. (Note that such a plan must be treated as a flat-benefit plan for purposes of the adjustment required for commencement of benfits before age 65. See page 20.)

Here are some examples of properly integrated "standard" using the maximum applicable benefit rate:

Example 1: The plan provides a normal annual retirement benefit equal to ½% of that part of an employee's final average annual pay not in excess of his "covered compensation" plus 1½% of such average pay in excess of "covered compensation," multiplied by his years of credited service. If the plan was established July 1, 1982 and covers only employees who had not reached age 65, the integration level can be any uniform dollar amount up to $10,800. (The integration level complies with Alternative 1, and the rate meets the 1% test for average compensation.)

Example 2: An employee earns a benefit credit for each year of his service equal to .6% of that part of his compensation up to the Social Security taxable wage base in that year plus 2% of that part of his compensation in excess of the taxable wage base. His annual normal retirement benefit is the sum of all his credits. (Here the integration level is Alternative 2, and the rate is the maximum rate for actual compensation.)

Example 3: A company puts in a plan effective January 1, 1983. The benefit for service *before* 1982 is equal to 1% of the employee's annual rate of compensation as of January 1, 1982 (or if lower, his average compensation during the last 5 years of employment) in excess of $10,800, multiplied by his years of service as of December 31, 1981 ("Covered compensation" from the 1982 age bracket table for a person reaching age 65 in 1982 is $10,800.) The benefit for each year of service *after* January 1, 1982 is equal to 1.4% of the employee's pay for the year in excess of $32,400. (Here the integration level complies with Alternative 3, the 1% past service rate applies to average compensation, the 1.4% future service rate to actual compensation.)

Suppose the company wanted the benefit for service before 1982 to be based on the $32,400 integration level used for service from 1982. Then the benefit rate for service before 1982 would have to be reduced to about .33% [($10,800

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(15) The 1% rate is reduced to .9% if pay is averaged over 3 consecutive years, .95% if averaged over 4 consecutive years.

divided by $32,400) × 1%]. In this case, the permissible variation in integration level is used with a proportionately reduced benefit rate.

OFFSET PLANS

[¶8] An offset plan will be properly correlated if the rate at which the offset to an employee's benefit is computed doesn't exceed 83-1/3% of the Social Security benefit provided on the basis of the Social Security law, and benefit levels, in effect at the time the employee retires or otherwise separates from service. Since ERISA specifically provides that increases in Social Security benefit levels, and increases in the Social Security taxable wage base, which occur after an employee separates from service (or begins to receive benefits, if earlier) must be disregarded,[16] the Social Security benefit to which the offset rate applies is the Social Security benefit which would be payable to the employee under the Social Security benefit levels in effect at the time the employee separates from service.

For example: A plan calls for a monthly benefit payable to an employee retiring at age 65 equal to 50% of his final 5-year average monthly earnings, *inclusive* of 83-1/3% of the employee's Social Security old age pension payable at age 65.

The offset can be expressed in terms of a small offset percentage for each year of credited service. For example, in a plan which recognizes no more than 40 years of credited service, the offset could be 2% for each year of credited service.

⋙**ANTI-BACKLOADING RULES**→ ERISA's anti-backloading vesting rules must be kept in mind if the offset per-year-of-service approach is used and a limit is placed on credited service for purpose of the offset but not for purposes of the "gross" benefit percentage. For example, a plan which has an age 25 requirement for participation and which provides for a normal retirement benefit commencing at age 65 equal to 2.4% of final average compensation for each year of participation, offset by 2% of the employee's Social Security benefit for each of the first 25 years of participation, will not meet any of the three anti-backloading accrual tests of Section 411(b)(1) of the Code.[17]

The offset rate can be higher than 83-1/3% if the offset to an employee's benefit is computed on the basis of the Social Security law as in effect before 1971—for example, the maximum offset rate is 92% if the offset is based on the Social Security Act Amendments of 1969. But the dollar amount of offset will be lower than if the current Social Security law and the 83-1/3% rate applied because of the substantial improvements in Social Security benefits since 1969.

ADJUSTMENTS FOR ADDITIONAL BENEFITS

[¶9] As we pointed out before, the Treasury derived the 37½% basic integration rate by converting the employer-financed *total* Social Security package into the equivalent of an employer-financed annuity payable only during the life of the employee, with no additional benefits. Thus the

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(16) IRC § 401(a)(15).
(17) Rev. Rul. 78-252, ¶95,083*.

integration rates we've been discussing so far apply only to noncontributory "standard" plans under which:

- There are no benefits payable in the case of death before retirement.
- The normal form of benefit is a straight life annuity (and optional forms are the actuarial equivalent of the life annuity).
- Normal retirement age is no lower than 65.
- Benefits payable in the case of retirement or any other severance before normal retirement age can't be greater than the actuarial equivalent of the portion of the maximum normal retirement benefit earned to the date of actual retirement or severance.

The maximum integration rate is reduced if the plan provides employer-financed pre-retirement death benefits, or if the normal form of retirement benefit is other than a life annuity. The maximum integration rate may also have to be reduced if benefits are payable before normal retirement age, such as integrated disability retirement benefits.

Death benefit adjustments: The amount of reduction in the benefit or offset rate for employer-financed pre-retirement death benefits depends on the type of death benefit provided.

Lump-sum benefits:

- When the benefit on death before retirement doesn't exceed the greater of the reserve or the total prior contributions on a typical individual level annual premium funding method (*e.g.*, individual policy plan), and there are no other death benefits or life insurance except a death benefit or life insurance *the current cost of which is includible in the employee's gross income,* the integration benefit or offset rate is reduced by 1/9th. Thus if a 1% benefit rate is otherwise permitted, the death benefit reduction would result in a maximum rate of 8/9 of 1%.

⋙**RETIREMENT INCOME POLICY**→ The death benefit under a typical retirement income contract is 100 times the employee's projected monthly pension. For a good many years, this death benefit will exceed the reserve or aggregate premiums. However, under Treasury Regulations the current cost of the "pure insurance"—*i.e.*, the excess of the face amount of the policy over the cash value—is includible in the employee's gross income.[18]

- Where the benefit on death before retirement is equal to 100 times the anticipated monthly pension (*i.e.*, the pension the employee would have received if he had lived to normal retirement age and his compensation remained unchanged), and *no portion of the current cost of such death benefit is includible in the* employee's gross income, the integration benefit or offset rate is reduced by 2/10ths. If the current cost of the death benefit protection is includible in the employee's gross income, the downward adjustment is 1/9th. So, for example, if an insured contributory plan provides a death benefit of 100 times the projected monthly pension and also provides that employee

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(18) Reg. § 1.72-16(b), ¶63,036*.

contributions are applied first to the current cost of insurance in excess of the cash value of the insurance, then the current cost of the "insurance" element is not includible in the employee's gross income and the downward adjustment to the integration rate would be 2/10ths, provided credit is not taken for the amount of such employee contributions in computing an increase in the integration rate for employee contributions (see page 25).

- Where the pre-retirement death benefit is equal to the greater of 100 times the anticipated monthly pension or the reserve on a typical individual level annual premium funding method, and *no portion of the current cost of such death benefit is includible in the employee's gross income,* the downward adjustment in the integration rate is 2/9ths.

Spouse's benefit: If the pre-retirement death benefit takes the form of a straight life annuity to the employee's spouse equal to 100%, or a lesser percentage, of the employee's accrued benefit (without regard to the age or sex of the employee's spouse), the integration rate is a fraction of the rate which would be allowable if the plan did not provide the spouse's benefit. The fraction is equal to 7 divided by the sum of 7 plus 2 times the fraction of accrued benefits continued to the spouse.

Example: A unit benefit plan provides a normal retirement benefit equal to 1% of actual compensation in excess of the Social Security taxable wage base for each year of service. If the employee dies before retirement but after age 50, the surviving spouse of the employee will receive a life annuity equal to the employee's accrued benefit.[19] The plan is integrated because the benefit rate does not exceed 1.08%-1.4% × 7/9. Seven divided by [7 + 2(1)] = 7/9. If the spouse's benefit were equal to one-half the employee's accrued benefit, the maximum benefit rate would be 1.2%-1.4% × 7/8. Seven divided by [7 + 2(½)] = 7/8.

➽ERISA PRE-RETIREMENT SURVIVOR ANNUITY→ ERISA requires under certain circumstances the payment of a pre-retirement death benefit in the form of a survivor annuity to an employee's spouse.[20] No adjustment is required in the integration rate to take account of such pre-retirement death benefit.[21]

Alternative actuarial rule: The reduction in the benefit or offset rate may be determined actuarially (for the case in which the death benefits are most valuable in relation to retirement benefits).

➽NO REDUCTION→ There's no reduction in the offset rate or the benefit rate of a step-rate plan if the death benefit is a non-integrated benefit related to pay (for example, 25% of a year's pay). There's no reduction in the benefit rate or offset rate if the pre-retirement death benefit protection is provided by the election of an actuarially equivalent optional form of benefit with the participant "paying" for the protection by way of a reduction in his benefit when he retires. Nor is there a reduction if the death benefit is merely a refund of employee contributions with interest, or if the benefit is provided by life insurance (with no cash value), the current cost of which is includible in the employee's gross income.

Normal form other than life annuity: When the normal form of retirement benefit under the plan is other than a straight life annuity, the applicable benefit rate or offset rate is reduced by multiplying such rate by the following percentages:

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(19) The spouse's benefit must be "incidental." See Rev. Rul. 70-611, ¶65,721*.
(20) IRC § 401(a)(11)(C).
(21) Internal Revenue Service News Release IR-1646, 7-28-76, ¶107,160*.

Form of Retirement Benefit	Percentage
Annuity for 5 years certain and life thereafter	97%
Annuity for 10 years certain and life thereafter	90%
Annuity for 15 years certain and life thereafter	80%
Annuity for 20 years certain and life thereafter	70%
Life annuity with installment refund	90%
Life annuity with full cash refund	85%
Life annuity with one-half continued to surviving spouse of employee	80%

➠**NOTE**→ The term "refund" refers to a refund of accumulated employer contributions. No adjustment is required for the refund of only employee contributions.

Here are two examples illustrating the reduction in the benefit or offset rate for pre-retirement death benefits and a normal form of benefit other than a life annuity:

Example 1: A noncontributory flat-benefit excess plan is funded by means of typical individual retirement income policies. The benefit in case of death before retirement is the face amount of the policy (100 times the employee's projected monthly pension) and the normal form of benefit is an annuity for 10 years certain and life thereafter. The plan calls for a benefit of 30% of average pay in excess of the employee's "covered compensation." The plan is properly integrated because the benefit rate doesn't exceed 30% (37½% × 8/9 × 90%). If the plan called for a unit-benefit based on actual excess compensation, the maximum rate would be 1.12% (1.4% × 8/9 × 90%); if based on final average pay in excess of "covered compensation," the maximum rate would be .8% (1% × 8/9 × 90%). If the plan called for a benefit offset by a percentage of the employee's Social Security old age pension, the maximum offset rate would be 66-2/3% (83-1/3% × 8/9 × 90%).

Example 2: A unit-benefit plan provides a normal annual retirement benefit equal to ½% of actual compensation up to the Social Security taxable wage base and 1.4% of such compensation in excess of the taxable wage base for each year of credited service. If the employee dies before retiring, the employee's surviving spouse will receive a life annuity equal to one-half of the employee's accrued pension. Upon an employee's death after retirement, the employee's surviving spouse will get a lifetime pension equal to 50% of the employee's pension. The plan is properly integrated because the actual difference in rates is .9% and thus does not exceed .98% (1.4% × 7/8 × 80%).

ADJUSTMENTS FOR EARLY RETIREMENT OR SEVERANCE BEFORE AGE 65[22]

[¶10] *Flat-benefit excess plan:* The maximum 37½% pension is payable only to an employee who works until age 65 (see page 15). A benefit payable on retirement or severance before age 65 can't be greater than the actuarial equivalent of the proportionate part of the maximum normal retirement benefit earned to the date of actual retirement or severance. Thus if an employee is entitled to a pension on retirement or termination of employment before age 65, with commencement of the pension payments *deferred* to age 65, his pension can't be greater than the maximum normal retirement benefit otherwise allowable, multiplied by this fraction:

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(22) The 3% method test for accrued benefits under IRC § 411(b)(1)(A) cannot be used when the normal retirement benefit is fully integrated because of the integration adjustments for early retirement or severance before age 65. The 3% method may be used if the normal retirement benefit is only partially integrated and the integration rules and § 411(b)(1)(A) requirements are both met. See Rev. Rul. 75-480, § 3.03, ¶95,021*.

number of years of employee's actual service
total number of years of service employee would
have had if he continued to work until age 65

However, if payments start *before* age 65—either because the normal retirement age is lower than 65 or because benefits or early retirement or severance may begin before age 65—the benefit otherwise payable at age 65 must be actuarially reduced to reflect the fact that benefit payments will be made over a longer period of time. Instead of an actuarial reduction, the benefit otherwise payable at age 65 can be reduced by 1/15th for each of the first 5 years and 1/30th for each of the next 5 years by which the benefit commencement date precedes age 65, and reduced actuarially for each additional year thereafter.

Unit-benefit excess plan: When a unit-benefit plan provides that an employee who retires or terminates employment before age 65 is entitled to a pension, with payment deferred to age 65, no adjustment is required in the basic 1.4% or 1% rate. That's because under a unit-benefit formula, the employee's pension is the sum of the unit benefit credits he's earned to the date of actual retirement or termination of employment.

➽WARNING→ A plan that expresses the benefit as a unit for each year of service, but is integrated only because it meets the flat-benefit integration requirements (see page 15), must adjust the benefit payable in case of early retirement or severance in accordance with the rules for flat-benefit plans.

If pension payments under a unit-benefit plan start before age 65, the maximum amount of the pension otherwise payable at age 65 must be actuarially reduced to reflect the longer payment period. Instead of an actuarial reduction, the maximum benefit otherwise payable at age 65 can be reduced by 1/15th for each of the first 5 years and 1/30th for each of the next 5 years by which the benefit commencement date precedes age 65, and reduced actuarially for each additional year thereafter.

For example: Let's say a career average plan (with no death or disability benefits) calls for a straight life annuity equal to ½% of the employee's pay for each year up to the Social Security taxable wage base plus 1½% of such pay in excess of the taxable wage base. An employee with at least 10 years of service may retire at age 62 and receive his full accrued pension. An employee may retire early after age 55 and 10 years of service, but his accrued pension will be reduced by 1/15th for each year he's under age 62 (and over age 60), and by 1/30th for each year he's under age 60 at early retirement. The plan is considered properly integrated because the difference in the rate of benefit payable at age 62—1%—doesn't exceed 1.12% (12/15 × 1.4%) and the benefit payable before age 62 is reduced by the 1/15-1/30 factors.

Offset plans: Where an offset plan provides benefits on retirement or severance before age 65, and payment is deferred until age 65, or plan benefits are not reduced by Social Security benefits until age 65, the amount of offset is figured by applying the maximum allowable offset rate to either:

- the Social Security benefit to which an employee would be entitled at age 65 assuming that he receives no wages for Social Security purposes after retirement or termination of employment, or
- the Social Security benefit to which the employee would be entitled at age 65 assuming he continues to receive until age 65 the same wages as at retirement or severance, reduced in the ratio that his years of service at retirement or severance bears to the years he would have had at age 65.

➡NOTE→ The Social Security benefit must be computed under the Social Security benefit formula and levels in effect at the time the employee separates from service because of the ERISA requirement that no increase in Social Security benefit levels, or taxable wage base, after separation from service be taken into account.[23]

If payments start before age 65, the benefit otherwise payable at age 65 must be reduced actuarially or by the 1/15th-1/30th rate for early commencement.

Example 1: ABC Company has a plan that covers all employees regardless of earnings. The benefit at normal retirement (age 65) is equal to 50% of the employee's average annual earnings less 50% of his or her old-age pension under the Social Security benefit levels in effect at the time he or she retires, with the net benefit proportionately reduced for less than 15 years of service. The plan also provides that upon an employee's death after retirement, the employee's surviving spouse will get a benefit equal to 50% of the employee's pension. If an employee retires or quits after completing 10 years of service but before age 65, he or she will receive a pension beginning at age 65, equal to 50% of average annual earnings less 50% of the old-age pension he or she is entitled to at age 65 (under the Social Security benefit levels in effect at the time of separation from service) based on the assumption that he or she doesn't work after retirement or termination of employment, with the net benefit proportionately reduced for less than 15 years of service. Instead of a pension to start at age 65, the early retiree or vested employee can elect to have the early retirement pension otherwise payable at age 65 start at any time after age 60, reduced by 1/15th for each year the commencement date precedes his or her 65th birthday. This plan is integrated because the offset doesn't exceed 66-2/3% (83-1/3% × 80%) and in case of early commencement the offset is appropriately limited.

Example 2: XYZ Company has a plan that covers all employees regardless of earnings. The benefit at normal retirement (age 65) is equal to (i) 1½% of the employee's final 5-year average monthly earnings, multiplied by the employee's years of service to age 65 (to a maximum of 40 years), less (ii) 1½% of the employee's old age pension under the Social Security benefit formula in effect at retirement, multiplied by years of service (to a maximum of 40 years). The normal form of benefit under the plan is an annuity for 10 years certain and life thereafter. An employee can retire early after age 55 and at least 10 years of service. If an employee leaves before age 55 but after completion of 10 years of service, he or she has a vested right to a pension beginning at age 65. An employee who retires, or leaves with a vested right, will receive a pension, beginning at age 65, equal to 1½% of final average monthly earnings for each year of service to a maximum of 40 years, less 1½% for each year of service (to a maximum of 40 years) of the old age pension to which the employee would be entitled at age 65 if he or she had continued to receive until age 65 the same wages as at retirement or termination, based on the Social Security benefit formula in effect at the time of early retirement or termination. The early retiree or terminated vested employee can elect to have the pension otherwise payable at age 65 start at or after age 55, reduced by 1/15th for each of the first 5 years and 1/30th for each of the next 5 years by which the benefit commencement date precedes age 65.

The plan is integrated because the offset rate for any employee (for a pension commencing at age 65) does not exceed 75% (83-1/3% × 90% adjustment for the normal form other

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(23) IRC § 401(a)(15).

than a life annuity), multiplied by a fraction equal to actual years of service divided by years of service the employee would have had at age 65; and in the case of commencement of benefits before age 65, the offset is limited by the 1/15th-1/30th reduction factors. Under the plan, the theoretically possible minimum fraction is about 10/50—for an employee who begins working at age 15 and leaves at age 25, so that the maximum offset rate (at age 65) for such an employee would be 15% (75% × 10/50), which is the offset rate under the plan (1-½% × 10).

If the plan had an age 25 requirement for participation and based the benefit and offset on years of participation, the minimum possible fraction would be 10/49—for an employee who started at age 16 and left at age 26—so that the maximum offset rate (at age 65) for such an employee would be 15.3%, considerably higher than the offset rate used by the plan of 1.5% for the one year of participation in the plan.

Individual policy plans: If an excess plan is funded solely by typical individual level premium annuity or insurance contracts, under which the benefit payable on early retirement or severance is the amount provided by the reserve, no adjustment is required in the applicable integration rate. If an offset plan is funded solely by such contracts, no adjustment is required for the commencement of payments before age 65.

DISABILITY BENEFITS

[¶11] *Excess plans:* If an excess plan provides that in case of retirement or severance for disability before age 65, a benefit will be payable commencing immediately for life or until recovery from disability before age 65, the following rules apply:

- The amount of the disability benefits payable for life, or until recovery from disability if the recovery occurs before age 65, may not exceed 70% of the *maximum* retirement benefit that could be paid as a normal retirement benefit if the employee had continued to work to age 65. But if the employee's actual years of service at disability retirement, as a percentage of the years of service he would have if he worked to age 65, is higher than 70%, the maximum disability benefit may be based on the higher percentage. In a unit-benefit plan, other than one treated as a flat-benefit plan (see page 12), disabled employees may receive the benefits they had already earned on the basis of their years of service to disability retirement, even if higher than 70% of the maximum benefit payable.

- The maximum rate at which the normal retirement benefit is provided must be reduced to 90% of the rate that would have been allowable if the plan did not provide disability benefits. Thus the maximum integration rates for excess plans that provide such integrated disability benefits are reduced to 33¾% [90% × 37½%] in the case of a flat-benefit plan, 1.26% [90% × 1.4%] in the case of a unit-benefit plan based on actual compensation and .9% [90% × 1%] in the case of a unit-benefit plan based on average annual compensation.

- The term "disability" must be defined in the plan, the rules for disability retirement must be uniformly and consistently applied to all employees in similar circumstances, and disability benefits under the plan must be payable only for the period of time when an employee is eligible for and *receives* Social Security disability benefits. However, a plan may provide that an employee who has applied for Social Security disability benefits is eligible for disability benefits under the plan pending subsequent favorable disposition of his application for Social Security disability benefits.

Example: A plan provides a flat benefit at retirement at age 65 after 15 years of service equal to 33¾% [37 ½% × 90%] of average pay in excess of "covered compensation." (There are no death benefits or other features requiring an adjustment in the basic rate.) If an employee becomes totally and permanently disabled after completing at least 15 years of service, he will receive a disability benefit, starting immediately, equal to 33¾% of his average pay in excess of "covered compensation," multiplied by a fraction, the numerator of which is his actual years of service, the denominator, the years of service he would have if he worked to age 65. Employee A retires because of disability at age 62 after completing 15 years of service. His disability retirement benefit will be 15/18 × 33¾% or 28-1/8% of his average pay in excess of his "covered compensation." Employee B retires for disability at age 45 after completing 20 years of service. His disability benefit will be 20/40 × 33¾% or 16-7/8% of his average pay in excess of his "covered compensation." Note that A's 28-1/8% benefit is greater than 70% of the 33¾% (23-5/8%) maximum normal retirement benefit.

Offset plans: If an offset plan provides benefits in the case of retirement or severance for disability before age 65:

- the amount of the offset to any employee's disability benefit before age 65 can't exceed 64% of the employee's actual Social Security disability benefit under Social Security Act in effect at the time of his retirement for disability, and
- the maximum offset rate to any employee's benefit after age 65 can't exceed 90% of the maximum offset rate which would otherwise be allowable if the plan did not provide integrated disability benefits. Thus the 83-1/3% maximum offset rate applicable to benefits computed under the Social Security law as in effect when the employee separated from service is reduced to 75% [90% × 83-1/3%] if the plan provides integrated disability benefits.

As in the case of excess plans, the term "disability" must be defined and the rules for disability must be uniformly and consistently applied.

Example: A plan provides a benefit at normal retirement (age 65) equal to 50% of an employee's average annual compensation less 75% of his old age pension under the Social Security benefit formula in effect at the time he retires. If an employee terminates for disability before age 65, he is entitled to a benefit, while remaining continuously disabled, until age 65 equal to 50% of his average annual compensation (computed as of the date he became disabled) less 64% of his actual disability benefit under the Social Security benefit formula as in effect at the time of his retirement for disability. At age 65 his benefit will revert to the normal retirement benefit (based on average annual compensation as of the date he became disabled). The plan integrates because the rate of offset after age 65 does not exceed 75% [90 × 83-1/3%] and the rate of offset to the employee's Social Security disability benefit does not exceed 64%.

Projected benefit payable after age 65: Where the only benefit an excess or offset[24] plan provides in case of retirement or severance due to disability before age 65, is a benefit payable commencing at age 65 and for life thereafter, and

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(24) Rev. Rul. 72-492, ¶65,888*.

the benefit does not exceed the maximum allowable benefit that could be paid as a normal retirement benefit if the employee had worked to age 65 at the same compensation he was receiving when he became disabled, no adjustment is required in the maximum integration rate otherwise allowable. However, the plan must provide that such benefit at age 65 based on projected service is payable only to an employee who is eligible for and *receives* Social Security disability benefits for the period of time from the date of disability (after the required Social Security waiting period) continuously until age 65. The plan must also define the term "disability" and the rules for disability must be uniformly and consistently applied.

Example: ABC Company's pension plan provides a normal retirement benefit at age 65 equal to 1% of an employee's final 5-year average pay in excess of $10,800 multiplied by his years of service at retirement. (There are no death benefits or other features requiring an adjustment in the basic rate.) The Company also has a long-term disability program that provides benefits in case of total and permanent disability, payable until age 65 or earlier recovery. The pension plan provides that if an employee retires for disability and is eligible for, and receives Social Security disability benefits until age 65, he will be paid from the pension plan a benefit commencing at age 65 equal to 1% of his average compensation in excess of $10,800 for the five years immediately prior to disability retirement, multiplied by the years of service he would have had if he had worked to age 65.

Plans not requiring Social Security disability benefits receipt: If the plan provides disability benefits which do not meet the requirements for integrated disability benefits, they will be treated as early retirement benefits which must meet the integration tests for early retirement benefits (see page 20).

EMPLOYEE CONTRIBUTIONS

[¶12] The 37½% flat-benefit (1.4% or 1% unit-benefit) pension is considered the measure of that part of the total Social Security benefit package *not* financed by the employee's own Social Security contributions. Thus if the employee contributes toward the cost of his benefits under the private plan on pay in excess of Social Security covered pay, the plan can provide a higher rate of benefit than the 37½% (1.4% or 1%) rate—as long as the difference in rates is attributable to the employee's own contributions. Employee contributions applied to the current cost of insurance or death benefits in excess of the reserve or cash value of a life insurance contract can't be taken into account for this purpose. However, if no credit for such amounts is given in determining the amount of death benefits (see page 18), the amounts can be taken into account to determine the increase for employee contributions.

In a unit-benefit plan basing benefits on actual compensation (career average), the maximum rate otherwise allowable may be increased by 1/6 of the rate of employee contributions.

Example: A plan provides a straight life annuity at age 65 equal to ½% of each year's pay up to the Social Security taxable wage base plus 2½% of such pay in excess of the Social Security taxable wage base. Employees are required to contribute 4% of pay in excess of the Social Security taxable wage base. The plan is integrated because the 2% difference in benefit rates (2½% - ½%) doesn't exceed 1.4% plus the increase for employee contributions of 1/6 × 4%, or 2.07%.

In a unit-benefit plan basing benefits on average compensation (final pay) the maximum benefit rate may be increased by 1/8 of the rate of employee contributions.

For example: The company adopts a plan effective January 1, 1982. The benefit for service before 1982 is equal to 1% of the employee's final 5-year average earnings in excess of $10,800 multiplied by his years of service as of December 31, 1981. The benefit for service from January 1, 1982 is equal to 1¼% of the employee's final 5-year average earnings in excess of $10,800, multiplied by his years of service from January 1, 1982 to retirement. Employees are required to contribute 2% of each year's earnings in excess of $10,800. The plan is properly integrated: (1) the rate of benefit for service *before* 1982 does not exceed 1%, the rate applicable to average compensation, and the integration level is the "covered compensation" of an employee reaching age 65 in 1982, (2) the rate of benefit for each year of contributory service does not exceed 1¼%—1% plus the increase for employee contributions of 1/8 × 2% (¼%)—and the integration level does not exceed the taxable wage base or covered compensation.

In the case of a flat-benefit excess plan, if the benefit is based on compensation averaged over a short period of time, such as the last 5 or 10 years of employment, the maximum benefit may be increased by 1/8 of aggregate employee contributions.

If the benefit in a flat-benefit excess plan is based on compensation averaged over the entire period of participation, the maximum benefit otherwise allowed may be increased by 1/6 of aggregate employee contributions.

➡BENEFITS BEFORE AGE 65→ The above increases in benefit or benefit rates apply only where benefits start at age 65. If the starting date of the annuity is earlier, the amount of the increase can't exceed the actuarial equivalent, which can be figured by using the 1/15—1/30 reduction for early commencement (see page 21).

PROFIT-SHARING AND MONEY-PURCHASE PENSION PLANS

[¶13] Up to this point, we've been considering plans that provide pre-determined benefits (defined benefit plans). Profit-sharing plans and money-purchase pension plans, however, do not provide pre-determined benefits. They are defined contribution plans.

Under a money-purchase pension plan, the employer makes fixed contributions each year which are credited to the individual employees' accounts. Amounts forfeited by employees who leave before they're entitled to benefits are used to reduce the current or following year's employer contribution. When an employee retires, the total amount of the employer's contributions (plus accumulations) in his account is used to provide him with retirement benefits.

A profit-sharing plan is similar to a money-purchase plan except that the employer's contributions are made from current or accumulated profits. The employer's contributions, together with the earnings and gains on the funds, are allocated among participating employees' accounts. Amounts forfeited by employees who leave are generally reallocated among the participating employees' accounts. When an employee retires, he gets the amount in his account.

To correlate a money-purchase pension plan with Social Security, the unit-benefit rate (see page 15) must be converted to a rate of employer contributions. To integrate a profit-sharing plan with Social Security, the unit-benefit rate must be converted to a rate at which employer contributions and forfeitures may be allocated to employees. The 1.4% unit-benefit rate is converted to a 7% employer contribution rate (or rate of allocation of contribution plus forfeitures).

Money-purchase pension plan: The integration level of a money-purchase plan may be one of the following:

- Each employee's "covered compensation" or a dollar amount that's not greater than the "covered compensation" of any present or potential participant—but in such case the integration level must be the same for all years in which the employee is credited with employer contributions.
- For any year of service, the Social Security taxable wage base for that year, or a lesser stated dollar amount.
- A higher dollar amount than any of the above levels, but then the maximum permissible rate of employer contribution must be reduced by multiplying the rate by the fraction:

$$\frac{\text{maximum allowable integration level}}{\text{plan's actual integration level}}$$

The maximum rate at which employer contributions can be applied to actual compensation in excess of the maximum integration level for any employee in any year is 7%. For example: A company can put in a plan on January 1, 1982 calling for the company to contribute each year 7% of each employee's compensation for the year in excess of $32,400.

A money-purchase pension plan which gives credit only for service after the inception of the plan may provide inadequate benefits for employees advanced in years when the plan goes into effect. That's why some employers may also provide benefits for service before the plan's inception.

When the employer provides benefits for service before the plan's inception, he has another choice for the plan's integration level: for years before the plan's inception, the "covered compensation" of an employee reaching age 65 in the year the plan is established (or a lesser dollar amount), and for years after the plan's inception, the Social Security taxable wage base (or a lesser dollar amount). If the benefits for service before the plan is established are based on a rate of benefit, then the limit on benefits is tied to the limit for a comparable unit-benefit plan. If the benefits for prior service are based on a rate of employer contributions applied to *average* compensation, the rate can't exceed 5%.

Example: The Y Company puts a plan into effect on January 1, 1982 covering all employees under age 65. The plan provides that the company will contribute with respect to each employee 7% of his actual compensation in excess of the maximum wages covered by Social Security each year from January 1, 1982 until he reaches age 65. In addition, each employee who has service before 1982 will receive a normal annual retirement benefit on a straight life annuity form commencing at age 65 equal to 1% of that portion of his annual compensation for the year 1981 (or if lower, his average annual compensation during the last 5 years of employment) which is in excess of $10,800, multiplied by his years of service as of December 31, 1981. The pension benefit for past service, as well as the money-purchase benefit for future service, would have to vest in accordance with ERISA requirements.

The plan is integrated: (1) For past service the integration level is the "covered compensation" (from the age bracket table) of a person reaching age 65 in 1982, and for future service, the Social Security taxable wage base. (2) The rate of employer contribution for future service applied to *actual* compensation in excess of the integration level doesn't exceed 7%. (3) The rate of benefit for past service doesn't exceed 1% applied to *average* compensation in excess of the integration level.

➽NOTE→ There's no need to adjust the money-purchase limit for additional benefits. The adjustments are made automatically since they are reflected in the amount of benefit produced by the accumulated employer contributions.

Profit-sharing plan: An excess profit-sharing plan may use any one of the following integration levels:

- The Social Security taxable wage base in effect each year, or a lesser stated dollar amount.
- Each employee's "covered compensation" or a dollar amount that doesn't exceed the "covered compensation" of any present or potential participant—but this level must be used for all years in which the employee is allocated employer contributions and forfeitures.
- A higher dollar amount than any of the above, but the integration rate must be multiplied by this fraction:

$$\frac{\text{maximum allowable integration level}}{\text{plan's actual integration level}}$$

➽OBSERVATION→ An integration level of "covered compensation" favors older employees who will be receiving less in the way of Social Security benefits. For example: Let's say that an excess profit-sharing plan uses "covered compensation" as the integration level. Employee A will be 65 in 1990, B in 2000. Using the 1982 age bracket table (page 13), employer contributions will be allocated to A's account on pay over $16,800, to B's account only on pay over $22,800.

The maximum rate at which employer contributions plus forfeitures may be allocated to any participant for any year based on his actual compensation for the year in excess of the integration level is 7%. The contributions must be allocated on a nondiscriminatory basis when made.

An integrated profit-sharing plan may provide benefits only on retirement, death or severance—and not during employment.

➽NOTE→ An integrated profit-sharing plan may provide for insurance on the lives of plan participants, even though the participants will be currently taxed on the "cost" of the life insurance protection. But it can't provide health and accident insurance or benefits.[25]

Here are two examples of integrated profit-sharing plans:

Example 1: A profit-sharing plan established in 1982 calls for the employer (not a Subchapter S corp.) to contribute each year out of profits an amount—inclusive of

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(25) Rev. Rul. 68-299, ¶65, 398*.

forfeitures—equal to 6.4% of each employee's compensation for the year in excess of $35,000. Contributions (inclusive of forfeitures) are allocated among employees in proportion to compensation in excess of $35,000. The plan is integrated because the rate of allocation of employer contributions and forfeitures doesn't exceed 6.4%-7% × $32,400/$35,000.

Example 2: A profit-sharing plan provides that the company will contribute each year out of its profits an amount to be determined by the Board of Directors, but not to exceed 15% of the total payroll of participating employees for the year. Company contributions plus forfeitures for the year are allocated as follows: First, each participating employee is allocated an amount in proportion to his compensation for the year up to the Social Security taxable wage base, but not to exceed 3% of such compensation. Second, each participant is allocated an amount in proportion to his compensation for the year in excess of the Social Security taxable wage base, but not to exceed 10% of such excess compensation.[26] Third, if there is any balance of contribution plus forfeitures remaining, the balance is allocated among the participants in proportion to each participant's total compensation for the year.

The plan is properly integrated. The 7% difference in allocation rates (10%-3%) applied to compensation in excess of the integration level doesn't exceed the permissible 7%. Since the allocation of the balance is made on the basis of all compensation, it does not involve integration.

VARIABLE BENEFIT AND COST-OF-LIVING PENSION PLANS

[¶14] Most pension plans are designed to provide employees with a fixed benefit at retirement. The pinch of inflation, however, has created a problem for such plans. The pension credits an employee earns on his actual pay during his working career may be sharply cut in value because of inflation. The purchasing power of his fixed dollar benefits at retirement may gradually dwindle over the span of his retirement years.

To meet the problem of inflation's inroads, the employer's plan can tie benefits or the value of pension credits or both to increases and decreases in the market value of the assets of the pension fund—generally referred to as a variable benefit plan—or to increases and decreases in a specified cost-of-living index. The theory behind the variable benefit approach is that the fluctuations in the value of the fund's equity investments will reflect changes in the cost and standards of living.

Obviously, the benefit payable under an integrated plan with a variable or cost-of-living feature could exceed the maximum benefit otherwise permitted. However, the mere fact that all or a portion of the benefits varies with the earnings of a specific fund or with fluctuations in a cost-of-living index will not, in and of itself, prevent the plan from integrating. Nor will the fact that earnings in excess of the rate assumed for employer contributions are used to increase employee's benefits, in and of itself, prevent a plan from being integrated.

If the benefit credits earned during employment vary due to fund earnings or fluctuations in a cost-of-living index, a limit may have to be placed on the benefit payable at retirement or severance. No limit is needed if the amount of

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(26) If the plan of a Subchapter S corporation covers a more than 5% shareholder-employee, compensation over $200,000 cannot be taken into account. IRC § 401(a)(17).

benefit *at* retirement or severance is pre-determined (and within permissible limits) and only the amount of benefit payable *after* retirement or severance varies with earnings of the pension fund or fluctuations in a cost-of-living index.

A plan that provides for benefit credits that vary with fund earnings will be integrated if, *at the time of retirement or severance,* the value of the benefits for any employee does not exceed the value of the maximum benefit which can be provided under an integrated pension plan of the same type. A plan can meet this requirement if it contains limits to insure that the benefits payable at retirement or severance won't exceed the maximum benefit otherwise permitted.

➡COST-OF-LIVING EXCEPTION→ No limit is needed if the benefit credits earned under a *career average* unit-benefit plan vary with increases or decreases in a cost-of-living index. No adjustment is necessary if the benefit payable *after* retirement under either a *career average* or *final average* unit-benefit or flat-benefit plan vary with fluctuations of a cost-of-living index.

An alternative test may be used for a *unit-benefit career average* pay plan that varies the employee's benefit credits with the fund's experience. Under that test, if the earnings of the fund in excess of the rate assumed in determining employer contributions with respect to all or a portion of the benefits under the plan are allocated in proportion to such benefits, the plan will be integrated if the assumed interest rate is at least 5½%. If the assumed rate is less than 5½%, the applicable integration rate is reduced by 1/15th for each ½ percentage point the assumed rate is less than 5½%.

Example: Under the Doe Company plan, established in 1972, an employee earns a benefit credit for each year of service equal to 1% of the first $9,000 of his pay for the year plus 2% of his pay in excess of $9,000. On joining the plan, the employee may elect to have 50% of the benefit credits he earns go into a variable fund, with the other 50% of his credits to be used to provide him with a fixed benefit at retirement. The benefit credit under the variable part is increased if the variable fund's earnings are in excess of the 4½% rate of earnings assumed in determining employer contributions.

The plan is integrated: (1) The maximum permissible integration rate for the plan is 1.4% (assuming no additional features requiring an adjustment to the 1.4% career average unit-benefit rate). (2) The plan's integration rate for the fixed-benefit portion is ½%-50% × (2%-1%). (3) Subtracting the ½% fixed-benefit integration rate from the 1.4% maximum permissible rate leaves a .9% maximum permissible rate for the variable benefit portion. (4) The .9% maximum permissible rate for the variable benefit portion, reduced by 1/15th for each ½ percentage point the assumed interest rate is less than 5½% (13/15 × .9%), equals .78%. The plan's ½% integration rate for the variable benefit—50% × (2% × .1%)—does not exceed .78%.

MULTIPLE INTEGRATED PLANS

[¶15] An employer can have more than one plan involving integration (*including both a pension and a profit-sharing plan*), if the extent of integration does not exceed 100%. The extent of integration of each plan is the ratio (expressed as a percentage) which the actual benefit, benefit rate, offset rate or employer contribution rate under the plan bears to the limitation applicable to the plan.

For example: In 1982 a company puts in a pension plan providing a straight life annuity at retirement at age 65 equal to .7% of each year's pay up to the Social Security taxable wage base plus 1.4% of pay in excess of the wage base. (There are no death benefits or other features requiring an adjustment in the integration rate.) The company also puts in a profit-sharing plan providing for a rate of employer contributions (inclusive of forfeitures) of 3½% of each employee's annual pay in excess of the Social Security taxable wage base. The extent of integration of the pension plan is 50%—the plan's actual integration rate of .7% (1.4%-.7%) divided by 1.4% (the maximum permissible integration rate). The extent of integration of the profit-sharing plan is 50%—3½% (the plan's actual contribution rate) divided by 7% (the maximum permissible employer contribution rate).

If the two plans do not cover overlapping compensation, the above limit does not apply.

For example: A company's pension plan provides a 1.4% benefit rate on pay *up to the Social Security wage base.* The company's profit-sharing plan provides for employer contributions inclusive of forfeitures of 14% of pay in excess of the Social Security wage base. The profit-sharing plan is integrated. (The pension plan does not involve integration with Social Security.) If the employer did not have the pension plan, the maximum employer contribution rate would be 7%. Since the ruling equates a 1.4% unit-bearing rate with a 7% employer contibution rate, the employer is in effect providing an employer contribution rate of 7% of pay up to the Social Security wage base, and 14% on pay in excess of the wage base—an acceptable differential rate of 7%.[27]

Related employers: The rules on multiple integrated plans apply to plans maintained by two or more employer members of an ERISA controlled group (*e.g.*, parent and 80% subsidiary, certain "brother-sister" corporations or businesses). So for example, if two business entities which are part of a controlled group have integrated plans which may cover some of the same employees, the multiple integrated plan limitation rules would apply.[28]

MINIMUM BENEFITS

[¶16] An integrated pension plan may provide for a minimum benefit attributable to employer contributions of $240 a year, or $8 a year for each year of service. An integrated money-purchase plan may provide for a minimum contribution of $48 a year. An integrated profit-sharing plan may provide for a minimum allocation of employer contributions (plus forfeitures) of $48 a year.

For example: A company's plan provides an annual benefit at retirement equal to 30% of final average annual earnings in excess of $10,800. Employee A retires with a final average pay of only $11,200. Ordinarily his annual benefit would be only $120. However, the plan provides him with a minimum benefit of $240 a year.

None of the minimums described above may be used as a tolerance. Nor may a minimum be used as a "floor" in determining whether higher benefits satisfy the integration requirements.

➠NOTE→ The limits on minimum benefits do not apply if there's no minimum compensation requirement for the minimum benefit or contribution. Nor do the limits apply if the minimum benefit or contribution doesn't involve integration with Social Security.

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(27) Rev. Rul. 81-202, ¶95,218*.
(28) Rev. Rul. 79-236, ¶95,109*.

An integrated plan may provide for the increase or decrease in monthly benefits, under a uniformly applicable rule, to the next multiple of $10 a month, or the rounding of monthly benefits to the nearest multiple of $10. Or a benefit schedule may be used with uniform benefits for all employees whose compensation falls within a particular bracket, provided the benefit in each bracket meets the integration rules when applied to compensation at the midpoint of the bracket and the brackets do not cover a range of compensation of more than $400 of annual compensation (larger brackets are permissible in some cases).

PENSION INTEGRATION—ISSUES AND COMPLICATIONS

(By Keith J. Goodell)

I am grateful for the opportunity to present our views on pension integration and to discuss some of the issues in designing an integrated pension plan.

United Technologies Corporation sponsors 50 domestic pension plans covering over 100,000 employees. Our plans provided $160 million of benefits in 1983 to 40,000 retired members. Plan assets equal $3.5 billion. In 1984 UTC will contribute $203 million to fund the pension plans.

UTC also contributes to another pension program . . . Social Security. The 1984 contribution for Social Security retirement benefits will be $140 million. Our employees will contribute an equal amount. This is exclusive of our contribution to the Health Insurance component of Social Security.

The 50 UTC plans can be categorized into plans which are implicitly integrated with Social Security, generally plans covering union employees, and plans which are explicitly integrated, generally plans which cover employees not represented by a union. I would like to concentrate on the latter category: the explicitly integrated plans.

Let us consider the characteristics of the largest UTC pension plan, which is explicitly integrated:

33,000 employees
21,000 retirees
$2.2 billion assets

The retirement benefit formula is:

2 percent salary times the first 20 years service and 1 percent salary times service after 20 years, integrated with 50 percent of Social Security benefit.

For our average employee the monthly benefit will be:

UTC pension	$850
Social Security	750
Total	$1,600

For employees at the lower and higher income ranges, the monthly figures are:

	Lower salary	Higher salary
UTC pension	$600	$2,070
Social Security	550	750
Total	$1,150	$2,820

Social Security benefits are better as a percent of pay for low wage earners. The system was designed that way to meet the basic needs of all retired workers. It is appropriate for a national social program to emphasize social adequacy.

UTC's pension program was designed with a goal of equitable benefits for all employees across the earnings range. Thus we believe a medium or higher paid employee should receive a benefit percentage from the combination of Social Security and our pension plan that is commensurate with the percentage for a lower paid employee, given similar service. Differences in the benefit percentages should reflect work related expenses, relative tax positions and amounts of disposable income. We have chosen to emphasize individual equity. Applying the rules for integration to our plan produces a combined benefit percentage (replacement ratio) which decreases as compensation increases, although not to the same degree as does the Social Security benefit by itself.

Let us review the major considerations that all plan sponsors should start with in designing an integrated pension plan. We would attempt to set a benefit level sufficient to attract, retain, and motivate competent employees. Benefits would be large enough to allow aging employees to retire with financial security. We would also determine the cost of the benefit program and adjust the benefit level as necessary.

In setting an appropriate benefit level we need to take Social Security into account. If we did not, one of two results would occur:

Certain employees would receive very high combined benefits while other employees would receive inadequate benefits.

The cost of the program would be substantially higher than justifiable.

UTC does not have an unlimited budget for the proper funding of our pension program. Thus we cannot ignore the substantial benefits our employees derive from the company contribution to Social Security. Integration with Social Security allows the most efficient benefit delivery for all employees from the contribution level that we have allocated.

A public employee retirement plan funded through tax revenue has the same considerations when the participants are covered by Social Security. A benefit structure must be designed to meet the retirement needs of a broad spectrum of employees, and at the same time avoid an undue financial burden on the taxpayers.

ISSUE

Consider the salary range for the group of employees to be covered by a new pension plan. If a narrow range exists, the Social Security replacement ratio is about the same for all employees. Integration can be accomplished implicitly, and the complementary pension replacement ratio can be determined.

If the salary range is broad, proper integration can only be accomplished explicitly, i.e., by directly mentioning the Social Security benefit in the pension plan formula:

Examples:

50 percent of final average pay integrated with 50 percent of Social Security benefit.

1½ percent of final average pay integrated with 1½ percent of Social Security benefit, for each year of service, maximum 35 years.

ISSUE

Social Security benefits are calculated using the earnings over an employee's entire career. How much credit for Social Security benefits should the company take for someone who is not a full career employee? There are basically two ways this is now handled:

Calculate the Social Security benefit using only earnings while in company employment.

Calculate the Social Security benefit assuming a full career of earnings, then prorate according to actual service with the company.

UTC uses the first method in determining Social Security benefits for our integrated benefit formula. Note, however, that government regulations do not require any reduction in the integrated Social Security benefit for employees with less than a full career with the company.

ISSUE

What if an integrated formula results in little or no pension benefit for lower paid employees? One solution would be to increase the pension formula for everyone. This is the expensive way. A better way is to establish a minimum benefit from the pension plan.

For example:

50 percent final average pay integrated with 50 percent of Social Security, with a minimum benefit of $10 for each year of service.

At UTC, the minimum benefit provision operates to assure a pension benefit for every retiree.

ISSUE

One of the major issues in inflationary times is the relative roles of Social Security and pensions after retirement. None of UTC's pension plans contains an automatic increase provision for post-retirement inflation. Such a provision is expensive and is uncommon among large companies.

Instead, in periods of high inflation, a company will often grant one time adjustments to current pensioners to help them maintain their standard of living at retirement. UTC granted such an increase, called an "ad hoc" increase, in 1979. There are three reasons we have not given additional ad hoc increases:

They are quite expensive.

Social Security benefits are fully indexed for inflation.

Inflation has moderated.

It is interesting to note that a lower paid employee receives a larger proportion of his total retirement benefit from Social Security than a higher paid employee. Thus the lower paid employee has a greater degree of inflation protection and is better able to maintain his standard of living at retirement. Higher paid employees, with relatively less inflation protection, generally have other sources of financial security to help maintain their standard of living.

In addition to our basic pension plan, UTC also sponsors a defined contribution savings plan. This plan is viewed as a supplemental plan. The company matches 50 percent of the employee's contribution of up to 6 percent. Assets accumulated at retirement will help improve our employees' financial security. Our savings plan is not integrated with Social Security.

ISSUE

With all the complex calculations for Social Security benefit determination, how can an integrated system be efficiently managed?

It is imperative to rely on a computer system for benefit calculations. The system must be reliable, efficient, and flexible. At UTC we maintain employment records for 60,000 employes on our data base system. When an employee is contemplating retirement, our pension technicians work interactively with the system to produce a pension status sheet. This provides a summary of all benefits and options. The Social Security benefit is automatically calculated through a subroutine installed and maintained by our actuarial consultant. The pension status sheet allows a retirement counselor to discuss accurate pension benefits with each employee nearing retirement.

ISSUE

What are the considerations in communicating benefit information to employees? An integrated benefit formula has the stigma of being difficult to communicate. This is likely due to the negative connotation of an "offset" component in the formula.

The most effective way to tell an employee about this pension benefit is to give him a personalized benefit statement. UTC provides annual benefit statements to all employees covered by the integrated pension plan. Accuracy and clarity are essential in benefit statements. The data for calculating benefits is accessed from the same data base used for recordkeeping.

Our benefit statement shows the benefit an employee is expected to receive at retirement from the pension plan and separately from Social Security. We concentrate on the results produced by the integrated benefit formula, not on the step-by-step process of deriving the benefit.

CONCLUSION

A pension plan integrated with Social Security is a highly efficient vehicle for delivering equitable retirement benefits. Proper design and management are essential for a successful program.

In the future, as design and financing questions arise, I would be pleased to discuss them with you.